ONLYIAS
BY PHYSICS WALLAH

UPSC WALLAH

ECONOMY
(PART I)

COMPREHENSIVE LEARNING SERIES FOR
PRELIMS AND MAINS

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A plethora of UPSC Study Material is available in the market but PW ONLY IAS professionals are continuously working to provide the supreme quality study material for our UPSC students.

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- Holistic coverage of topics, strictly as per exam syllabus
- One-stop solution for subject wise coverage
- Intensive use of Maps, Diagrams, Flowcharts and Timelines for quick understanding and revision
- Thinking Points in and as ‘Ignite Your Mind’
- Updated with latest current affairs and data

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Microeconomics and Basic Terminology

1

AN OVERVIEW TO THE DISCIPLINE OF ECONOMICS

- **Origin of Economics:** The term 'Economics' is derived from the Ancient Greek word 'oikonomikos', which means household management.
- **Definition and Scope:** Economics is a broad and diverse discipline that focuses on the study of how individuals, businesses, governments, and societies make choices about allocating limited resources to satisfy their needs and wants.
- **Branches of Economics:** Economics is divided into Microeconomics and Macroeconomics, focusing on individual units and overall economic aggregates, respectively.

A CONCISE HISTORY OF ECONOMICS AND ITS SCHOOLS OF THOUGHT

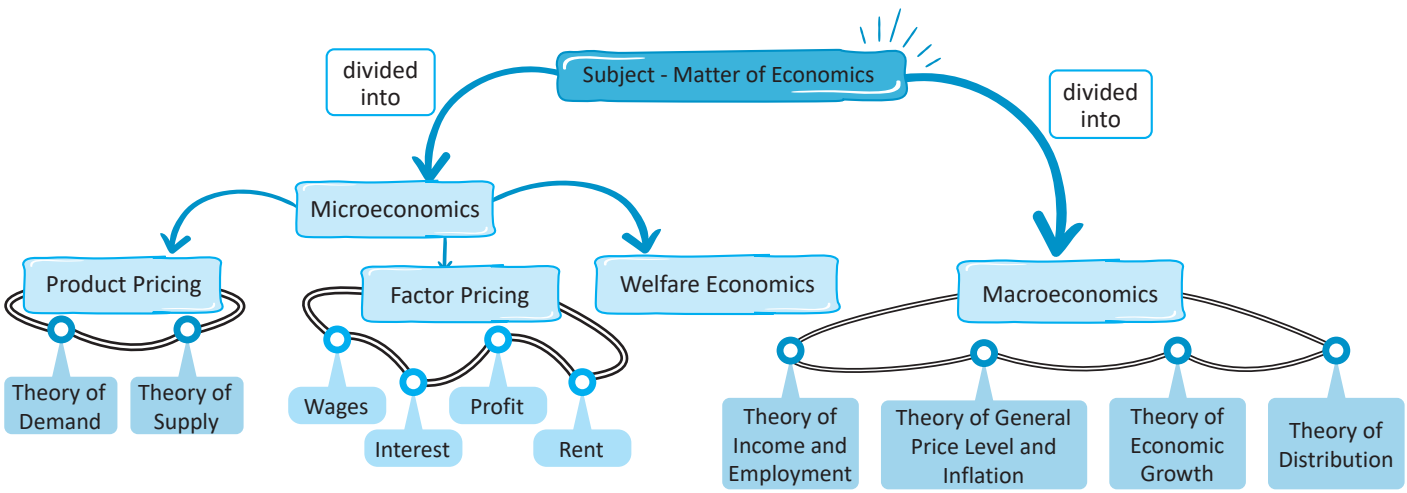


Fig. 1.1: Basics of Economics

Early Economic Thought

- **Ancient Greece:** Philosophers like Plato and Aristotle discussed economic justice, wealth accumulation, and division of labor.
- **Mercantilism:** It stressed on government intervention for national wealth through trade surpluses and gold accumulation.

Classical Economics

- **Adam Smith:** He authored "The Wealth of Nations", advocating for free markets and the invisible hand to ensure economic efficiency.
- **David Ricardo:** He formulated theories of comparative advantage, rent, and wages.
- **Thomas Malthus:** He predicted population growth surpassing food production, leading to famine and social unrest.

Neoclassical Economics

- **Marginalism:** It focused on marginal benefits and costs in decision-making and market equilibrium.
- **Alfred Marshall:** He developed theories of supply and demand, consumer behavior, and firm production.
- **Leon Walras:** He formulated a general equilibrium model, examining interconnected markets.

Keynesian Economics

- **John Maynard Keynes:** He challenged self-correcting markets, advocating government intervention through fiscal policy for economic stability.

Modern Approaches

- **Monetarism:** It concentrates on money supply and central bank policy's influence on economic activity.
- **New Keynesian Economics:** It integrates Keynesian ideas with microeconomic foundations to analyze economic fluctuations and policy responses.
- **Behavioral Economics:** It incorporates psychology and cognitive biases into economic models, explaining deviations from rational behavior.

Additional Approaches

- **Marxist Economics:** It analyses capitalism through a class struggle lens, focusing on exploitation and power dynamics.
- **Institutional Economics:** It emphasises the role of institutions in shaping economic behavior and outcomes.
- **Feminist Economics:** It studies gender inequalities, advocating for policies promoting economic justice and equality.

This succinct overview traces the development of economic thought, shedding light on diverse perspectives that enrich our comprehension of the intricate world of economics.

Microeconomics and Macroeconomics

Aspect	Description
Microeconomics	It studies economic behaviour of individual units like consumers, households, and firms, particularly in decision-making and resource allocation.
Macroeconomics	It focuses on broader economic factors such as national income, employment, inflation, and economic growth.
Interdependence	Microeconomics and Macroeconomics are interdependent, each providing essential insights for a comprehensive understanding of economics.

UNDERSTANDING MICROECONOMICS

Scarcity, Choice, and Opportunity Cost in Microeconomic Thinking

The foundation of microeconomic thought revolves around the central concept of decision-making within the constraints of scarcity and the inherent trade-offs involved. In the economic landscape, where resources are limited and have diverse potential uses, individuals, consumers, and producers must grapple with choices. The customers demand goods and services and the producers offer these for sale, but none of the individuals can acquire everything they require from the economic system. Decisions necessitate trade-offs, and for every choice made, an alternative option is forfeited.

Consider a scenario where an individual decides to purchase a car. In making this choice, they forego the opportunity to use the same funds for a holiday. Here, the holiday represents the opportunity cost of choosing to buy the car. This principle extends beyond individuals to firms, which, in deciding what to produce, inevitably exclude alternative goods and services from their production.

In the realm of production, firms face decisions about the quantity to produce and for whom. While a simplistic approach might advocate for maximizing production using all available resources, classical economists introduce the law of diminishing returns. According to this law, as variable factors of production (like labor) are continually added to fixed factors (such as land), the additional output generated per unit of added factor diminishes proportionally. Eventually, a point is reached where overall output starts to decrease with each additional unit of factor added.

The Price Mechanism in Microeconomics

A significant portion of microeconomics focuses on the examination of how prices are established in markets. Markets serve as platforms where producers and consumers converge. While early economies relied on physical locations for trade, contemporary markets often operate through indirect interactions, facilitated by means such as post services and the internet.

Within these markets, supply and demand, generated by producers and consumers, respectively, converge to form the price mechanism. This mechanism, famously referred to as the 'invisible hand,' orchestrates the actions of producers and consumers, determining the prevailing prices.

The necessity of markets in producing essential goods and services is evident. Even if individuals can produce their own food, they still require various other necessities like clothing and shelter. Consequently, communities recognized the benefits of exchange early on. Barter was an initial form of exchange, but the advent of money accelerated the process as a medium of exchange and unit of account.

The challenge arose of how individuals would determine appropriate prices for their goods and services. Traders discovered that setting prices too low led to inventory depletion, while prices set too high resulted in unsold products. In physical markets with perfect knowledge, traders could easily compare prices. However, as markets become more remote, the certainty of this process diminishes.

Alfred Marshall, through his 1890 publication "Principles of Economics," significantly contributed to the understanding of supply and demand, elasticity, revenues, costs, and marginal utility. Marshall's ideas laid the foundation for the formal analysis of supply and demand, playing a crucial role in comprehending the determination of prices in markets.

Demand Side of Economy

- **Law of Demand:** The Law of Demand states that, all else being equal, as the price of a good or service increases, consumer demand for that good or service will decrease, and vice versa. For example, if the price of smartphones decreases, consumers are likely to purchase more smartphones. Conversely, if the price increases, the demand for smartphones typically drops. This inverse relationship between price and quantity demanded is a fundamental principle of consumer behavior in economics.
- **Determinants of Demand:** It includes price, consumer income, tastes/preferences, prices of related goods, and future expectations.

- Substitute goods are pair of competing goods which, in the opinion of buyers, can replace each other. For example, if tea is costly, buyer may drink coffee.
- Complementary goods are pair of goods that are interdependent or compatible. For example: Bread and jam, Tea and sugar etc.

❑ **Elasticity of Demand:** It measures how quantity demanded responds to price changes.

❑ **Demand Curve:** For any change in price, there is an inverse change in quantity demanded. The price decrease from OP0 to OP1 results in a increase in quantity demanded from OQ0 to OQ1.

Normally, the demand slopes downwards from left to right. But there are some unusual demand curves which do not obey the law/usual demand curve. For them, a fall in price brings about a contraction of demand and a rise in price results in an extension of demand. Therefore, the demand curve slopes upwards from left to right. It is known as **exceptional demand curve.**

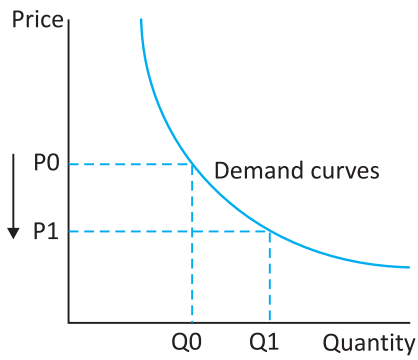


Fig. 1.2: Demand Curve

Vebeln Effect-Conspicuous Consumption/Luxury Goods means spending of money on luxury goods and services to display financial power. Demand for Veblen goods increases with rise in their price. For example - A Rolex watch or Rolls Royce car is desirable because of their high price and associated status symbol.

Giffen Goods are goods with the unique characteristic that an increase in prices actually increases the quantity of the good that is demanded. The generally accepted explanation is that Gifen goods are a type of inferior good without a substitute. For example, when the price of rice increases, people cannot shift out of rice but rather eat only rice instead of other vegetables.

Speculative effect reverses the demand curve due to expectation of certain future events. If the price of the commodity is increasing then the consumers will buy more of it because of the expectation that it will increase still further. For example: stock markets.

Supply Side of Economy

❑ **Law of Supply:** The Law of Supply states that, other things being equal as the price of a good or service increases, the quantity supplied of that good or service also increases, and vice versa. For instance, if the market price of coffee beans rises, farmers are incentivized to grow more coffee beans, increasing the supply. Conversely, if prices fall, farmers may reduce their coffee production due to lower profitability. This principle illustrates the direct relationship between price and supply in economics.

❑ **Determinants of Supply:** It is influenced by factors like commodity price, production costs, taxes, and profit objectives.

❑ **Elasticity of Supply:** It indicates the responsiveness of quantity supplied to price changes.

Supply Curve

There is a direct relationship between price and quantity supplied. An increase in price from OP1 to OP2 results in an increase in quantity supplied from OQ1 to OQ2.

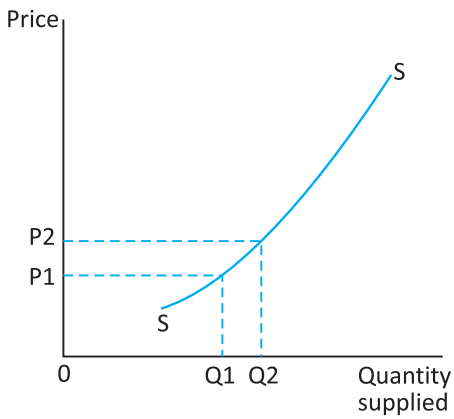


Fig. 1.3: Supply Curve

MARKET EQUILIBRIUM AND COMPETITION

❑ **Market Equilibrium:** It occurs when quantity demanded equals quantity supplied, determining the market price. For example, at a bakery, market equilibrium is reached when the amount of bread produced daily is sold out at closing time without leftovers or shortages.

Price is determined at the intersection of the supply and demand curves.

Setting the price above the equilibrium leads to a surplus, where quantity supplied exceeds quantity demanded. To clear inventory, the company must lower the price.

Conversely, setting the price below equilibrium causes excess demand. The only remedy is to increase the price.

Theory of The Firm in Microeconomics

The theory of the firm, a microeconomic branch, explores diverse organizational structures within industries and draws insights from these structures.

Perfect Competition

In a perfectly competitive market:

- Numerous firms produce identical goods.
- No barriers impede entry or exit.

Producers and consumers possess perfect market knowledge.

- In this scenario, prices and output levels gravitate towards equilibrium. The demand curve is perfectly elastic, indicating horizontal demand. Real-life instances of perfect competition are rare, but some financial markets and certain online commerce sectors align with its principles.

Monopoly

Monopoly occurs when a single producer dominates the market. Laws often define monopoly less strictly, considering firms with a specific market share. Monopolies may arise due to statutory rights or government ownership. A monopoly can set its own prices, leading to super-normal profits. Government regulation is common to control monopoly power.

Oligopoly

Oligopoly arises when a few influential producers dominate a market, with a duopoly being the minimum form. These producers have substantial knowledge about competitors' actions and can predict responses to strategy changes. Oligopolistic markets often feature complex product differentiation, entry barriers, and significant price influence by a few large producers.

Monopolistic Competition

Monopolistic competition involves many producers using product differentiation to distinguish themselves. Despite similar products, perceived differences allow short-term monopolistic behavior. Consumer awareness of product distinctions is essential, and barriers to entry or exit are typically lower than in oligopolistic markets.

Market Intervention in Capitalist Systems

In capitalist systems, the principle of allowing markets to operate freely is generally favored. However, there is a recognition that certain goods and services, termed 'public goods and services, require intervention for adequate provision. This intervention, often led by governments or supra-national organizations, involves setting prices either above or below the equilibrium price.

Maximum Price Intervention: Safeguarding Consumers

The imposition of a maximum price aims to protect consumers. This results in a situation where the quantity demanded surpasses the quantity supplied, provided the maximum price is set below the equilibrium price. Historical examples, such as the UK government's intervention during World War-II, highlight the potential consequences, including excess demand and the emergence of illegal markets.

Minimum Price Intervention: Protecting Producers

Conversely, a minimum price is sometimes enforced to shield producers. In this scenario, the quantity supplied exceeds the quantity demanded if the minimum price is set above the equilibrium price. The European Union's common agricultural policy, implementing a minimum price system, has periodically led to surpluses in the agricultural sector.

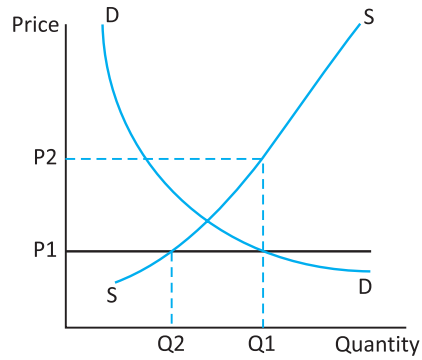


Fig. 1.4: Market intervention mechanism

Managing Consequences: Insights from Microeconomic Analysis

While the impact of intervention in the price system may not always be universally undesirable, microeconomic analysis emphasizes the need to understand and manage the consequences effectively. Society must navigate the implications of such interventions to ensure a balanced and efficient economic system.

Maximum price is OP1. At this point, the quantity demanded (OQ1) exceeds quantity supplied (OQ2). The 'black market' price is OP2.

Elasticity of Demand and Supply

Elasticity in economics refers to how quantity demanded or supplied responds to changes in price. If a slight price change results in a substantial shift in quantity demanded, it indicates high elasticity. Conversely, if a price change has minimal impact on the quantity demanded, the demand is considered highly inelastic. Producers rely on this concept to predict the effects of pricing strategies, while government finance departments use it to model tax implications.

The price elasticity of demand is calculated by dividing the change in quantity demanded by the change in price. Similarly, the price elasticity of supply is determined by dividing the change in quantity supplied by the change in price. Elasticity of demand occurs when a price increase leads to reduced total revenue, while inelasticity results in increased total revenue. Unitary elasticity occurs when a change in price causes no change in total revenue.

In addition to price elasticity, there are other relevant concepts:

- **Income Elasticity:** Measures how quantity demanded or supplied responds to changes in income.
- **Cross Elasticity:** Examines how the quantity demanded or supplied of one good responds to changes in the price of another good.

Elasticity of Demand

- **Perfectly Elastic Demand:** Infinite change in quantity demanded for a very small change in price.
- **Perfectly Inelastic Demand:** No change in quantity demanded regardless of price changes.

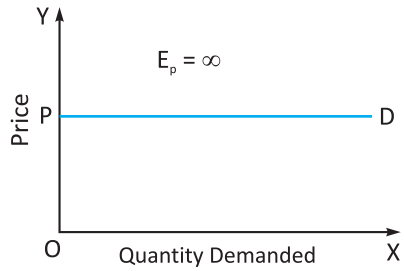


Fig. 1.5: Perfectly Elastic Demand

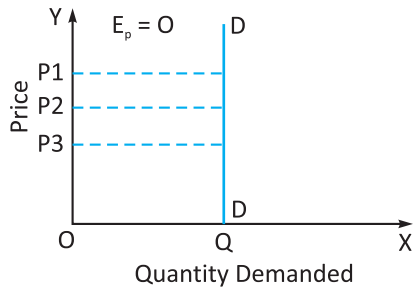


Fig. 1.6: Perfectly Inelastic Demand

- **Relatively Elastic Demand:** Large change in quantity demanded for a small change in price.
- **Unitary Elastic Demand:** Proportional change in quantity demanded equals the change in price.
- **Relatively Inelastic Demand:** Small change in quantity demanded for a large change in price.

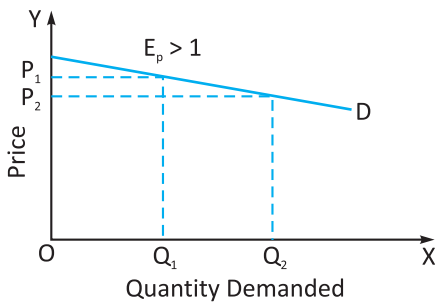


Fig. 1.7: Relatively Elastic Demand

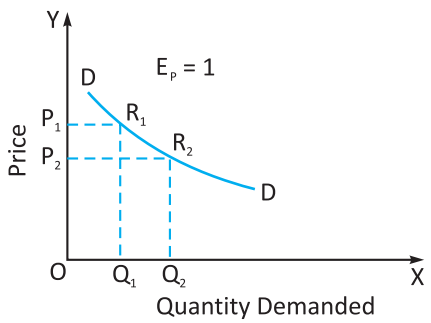


Fig. 1.8: Unitary Elastic Demand

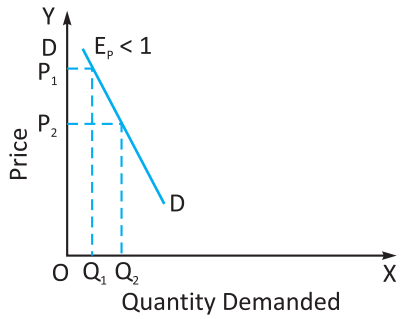


Fig. 1.9: Relatively Inelastic Demand

Elasticity of Supply

- **Relatively Elastic Supply:** More than proportional change in quantity supplied due to price change.
- **Unitary Elastic Supply:** Proportional change in quantity supplied equals the change in price.
- **Relatively Inelastic Supply:** Less than proportional change in quantity supplied due to price change.
- **Perfectly Elastic Supply:** Infinite change in quantity supplied for a very small change in price.
- **Perfectly Inelastic Supply:** No change in quantity supplied regardless of price changes.

During the COVID-19 pandemic, the price of masks went up because a lot of people needed them, and companies made more masks to meet the demand illustrating elastic supply. However, we couldn't suddenly have more doctors, so the number of doctors didn't increase much. This is an example of relatively inelastic supply.

Some Basic Terms and Concepts

- **Marginal Utility:** The additional satisfaction gained from consuming an additional unit of a good or service.
- **Opportunity Cost:** The cost of foregone alternatives when one option is chosen over another.

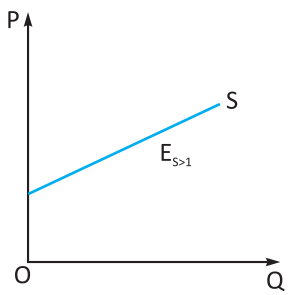


Fig. 1.10: If Es>1, Supply is elastic

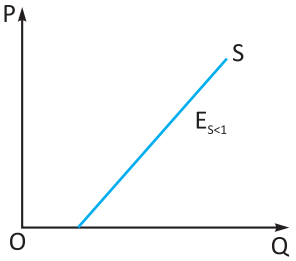


Fig. 1.11: If Es<1, Supply is inelastic

- **Market Equilibrium:** A situation in which market supply and demand balance each other, resulting in stable prices.
- **Externalities:** Costs or benefits that affect a party who did not choose to incur that cost or benefit.
- **Substitution Effect:** The change in consumption resulting from a change in the price of a good, making consumers substitute away from higher-priced goods to lower-priced ones.
- **Income Effect:** The change in consumption resulting from a change in real income.
- **Marginal Cost:** The cost of producing one additional unit of a good.
- **Diminishing Marginal Returns:** A principle stating that as investment in a particular area increases, the rate of profit from that investment, after a certain point, cannot continue to increase if other variables remain constant.
- **Price:** The amount of money required to purchase a good or service.
- **Cost:** The expenses incurred in producing or acquiring a good.
- **Income:** Monetary or other returns, earned or unearned, accruing over a period.
- **Goods and Services:** Tangible products (goods) and activities performed by service providers (services).
- **Final Good:** A product that has completed its production and transformation process.
- **Consumption Good:** Goods and services consumed upon purchase.
- **Capital Good:** Assets used in production that do not undergo a transformation in the process.
- **Fixed Asset:** Business assets used for more than one accounting year.
- **Depreciation:** Decline in value of fixed assets over time due to use or obsolescence.

CONCLUSION

Microeconomics is not just a theoretical framework; it is a practical tool-kit that offers invaluable perspectives for various stakeholders - from policymakers and business leaders to individual consumers. Its principles permeate every aspect of economic life, enabling a deeper understanding of the economic forces that shape our daily experiences and the broader global economy.

National Income and GDP

2

INTRODUCTION

National Income serves as a vital metric and reflects a nation's economic health by quantifying its total output of goods and services over a specified time. It measures a country's economic performance and reveals its productivity and standard of living. Computed through various methods, including expenditure, income, and production approaches, national income evaluation aids in policymaking, economic planning, and gauging the overall economic well-being of a nation.

THE CIRCULAR FLOW OF INCOME

The circular flow of income describes how money flows through an economy. It is a simplified representation of the complex interactions between different sectors of the economy, including households, businesses, the government, and the rest of the world.

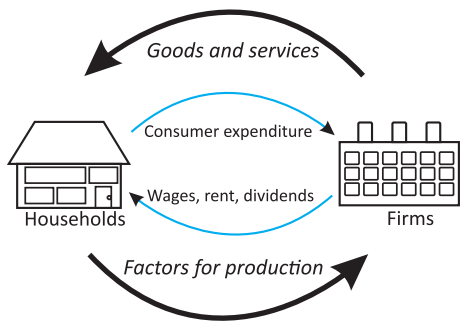


Fig. 2.1: Circular Flow of Income

Main Components of The Circular Flow of Income

- **Households:** Households supply **factors of production** (land, labour, capital, and entrepreneurship) to businesses and receive income in return. They use this income to purchase goods and services produced by businesses.
- **Businesses:** Businesses use the factors of production supplied by households to produce goods and services. They sell these goods and services to households and other businesses and receive income in return.
- **Government:** The government collects taxes from households and businesses and uses this revenue to provide public goods and services, such as education, healthcare, and infrastructure.
- **Rest of the World:** The rest of the world includes all other countries, and it represents the flow of imports and exports. Households and businesses can import goods and services from the rest of the world, and they can also export goods and services to the rest of the world.

The Circular Flow of Income Can Be Broken Down into Two Flows

- **The flow of goods and services:** This flow goes from businesses to households and the government, and then back to businesses again.
- **The flow of money:** This flow goes from households to businesses and the government in the form of factor payments and taxes, and then back to households again in the form of income and government transfers.

The Circular Flow of Income is a Useful Tool For Understanding Some of The Key Relationships in an Economy

- It shows how different sectors of the economy are interconnected.
- It demonstrates how money flows through the economy.
- It helps to explain how changes in one sector of the economy can have ripple effects throughout the rest of the economy.

However, it is important to remember that the circular flow of income is a simplified model, and it does not capture all the complexities of a real economy.

Limitations of The Circular Flow of Income

- It assumes that all markets are perfectly competitive.
- It does not consider the role of financial institutions.
- It does not explicitly model the role of aggregate demand and supply.

Despite its limitations, the circular flow of income is a valuable tool for understanding the basic principles of how an economy works.

RELATIONSHIP BETWEEN FACTORS OF PRODUCTION AND FACTORS OF INCOME

Factors of production are the resources used to create goods and services, while factors of income are the payments received by the owners of these resources.

In simpler terms, what you use to produce something (factors of production) determines what you get paid for it (factors of income).

Factor of Production	Factor of Income
Land	**Rent:** Payment for the use of land and natural resources.
Labour	**Wages and Salaries:** Payment for the time and effort of workers.
Capital	**Interest:** Payment for use of capital goods like machinery and equipment.
Entrepreneurship	**Profit:** Earnings from successful business ventures.

Relationship is Essential For Several Reasons

- **Analysing the distribution of income:** Who gets what and why in an economy.
- **Formulating economic policies:** Policies like taxation and minimum wage can influence the allocation of income.
- **Understanding economic inequality:** How wealth and income are distributed across different groups in society.
- **Making informed business decisions:** Costs associated with using different factors of production and potential income generated.

NATIONAL INCOME

- National income refers to the money value of all the goods and services produced in a country during a financial year. In other words the final outcome of all the economic activities of the nation during a period of one year, valued in terms of money, is called National income.

  OR

  National income of a country is the sum of income earned by its residents from the factor services rendered to the production units both within and outside the geographical boundaries of the country.
- Measured over a specific period, usually the accounting year (April 1st to March 31st).
- **Resident concept:** It focuses on income earned by residents, regardless of location of production.
- **Final goods and services:** It considers only final goods for consumption, excluding intermediate goods used in production.
- It is primarily measured through Gross Domestic Product (GDP), which represents the total value of final goods and services produced within the country's borders.
- **Variants of GDP:**
  - Net Domestic Product **(NDP)**: GDP - depreciation (wear and tear of capital goods).
  - Gross National Product **(GNP)**: GDP plus net income earned from abroad by residents.
  - Net National Product **(NNP)**: GNP minus depreciation.
- The calculation of National Income aggregates takes into account two distinct approaches: factor cost and market price.

Gross Domestic Product (GDP)

A measure of the value of the aggregate amount of goods and services produced by the economy in a year is called Gross Domestic Product (GDP). Thus, GDP = Sum total of Gross Value Added (GVA) of all the firms in the economy.

OR

It is the money value of all final goods and services produced in the domestic territory of a country during an accounting year.

HISTORY OF NATIONAL INCOME IN INDIA

Pre-Independence Period (Before 1947)

- Early attempts to estimate national income were made by individuals like **Dadabhai Naoroji** and **V.K.R.V. Rao**.
- These estimates were based on limited data and relied on indirect methods.
- Lack of reliable data and standardised methodology made comparisons across time and space difficult.

Early Post-Independence Period (1947-1955)

- **P.C. Mahalanobis** led the National Income Committee under the Indian government, comprising members **D.R. Gadgil** and **V.K.R.V. Rao**.
- The Committee's inaugural report in 1951 disclosed India's National Income for 1948-49 as 8,710 crore with a Per Capita Income (PCI) of Rupee 225.

Central Statistics Office (CSO) Establishment

- Initially, the estimation of Gross Domestic Product (GDP) was handled by the CSO, which developed a comprehensive National Income division at the national level.
- Since 1955, CSO has compiled National Income estimates based on national-level surveys conducted by the National Sample Survey Office (NSSO).

Formation of National Statistical Office (NSO)

In 2019, the Central Government merged CSO and NSSO, establishing the NSO under the Ministry of Statistics and Programme Implementation (MoSPI).

The NSO was created to implement statistical standards and coordinate statistical activities as recommended by the Rangarajan Commission.

Structure of NSO

The NSO operates with three Director Generals (DG): DG (Statistics), DG (Coordination, Administration, and Policy), and DG (National Sample Survey), reporting to the Secretary (S&PI).

Role of National Statistical Commission (NSC)

Formed in 2005 on the Rangarajan Commission's recommendation, NSC operates as an autonomous body.

It aims to address challenges faced by statistical agencies in the country, focusing on data collection and standards, with the Chief Statistician of India and Secretary, MoSPI, serving as the Secretary to the Commission.

Various Committees and their Recommendations on Calculating India's National Income

National Income Committee (NIC) (1949)

- Introduce a comprehensive system of national income accounting, including all sectors and income sources.
- Utilize the 'Product Method' as the primary method for calculating national income.
- Emphasize the importance of estimating income generated by the informal sector.
- Establish a central agency to collect, compile, and publish national income data.

Roy Committee (1951)

- Recommended improvements in the estimation of agricultural income and income from small-scale industries.
- Emphasised the need for reliable data on consumption expenditure and investment.
- Suggested the use of sampling techniques to improve data collection.

Mahalanobis Committee (1960)

- Proposed the adoption of the 'Value Added Method' for calculating national income.
- Recommended the development of a comprehensive system of input-output tables.
- Advocated for the strengthening of statistical infrastructure and training of personnel.

Rao Committee (1961)

- Emphasised the need for a more accurate estimation of income from various sources, including rent, profits, and wages.
- Recommended the use of multiple methods for cross-checking and validating national income estimates.
- Proposed the development of a system of national accounts that conforms to international standards.

National Accounts Advisory Committee (NAAC) (1998)

- Recommended the adoption of the latest international standards for national income accounting (SNA 1993).
- Emphasized the importance of incorporating the informal sector into the national income accounts.
- Suggested the use of new data sources, such as administrative records and surveys, for improving data quality.

Working Group on National Income Statistics (2012)

- Proposed the adoption of SNA 2008 for national income accounting.
- Recommended the development of new methods for estimating income from various activities, including agriculture, small-scale industries, and the informal sector.
- Emphasized the need for strengthening the capacity of statistical institutions for data collection and analysis.

Sources of National Income Data in India

- National Statistical Office (NSO)
- Annual Survey of Industries (ASI)
- Economic Census
- Administrative records
- Household surveys

To Calculate National Income, The NSO Classifies The Indian Economy into Three Sectors

- **Primary Sector:**
  - This sector involves activities related to natural resources and raw materials. It includes:
    - **Agriculture:** Cultivation of crops, animal husbandry, forestry, and fishing.
    - **Mining and Quarrying:** Extraction of minerals, ores, and natural resources.
- **Secondary Sector:**
  - This sector encompasses activities involved in manufacturing and processing raw materials into finished goods. It includes:
    - **Manufacturing:** Production of goods from raw materials, such as textiles, automobiles, machinery, etc.
    - **Construction:** Building and infrastructure development activities.
- **Tertiary Sector**
  - Also known as the service sector, this involves services provided to individuals and businesses. It includes:
    - **Services:** A wide range of services like healthcare, education, hospitality, finance, transportation, communication, and IT.

A Comparative Look at India's GDP: Sector-by-Sector Breakdown

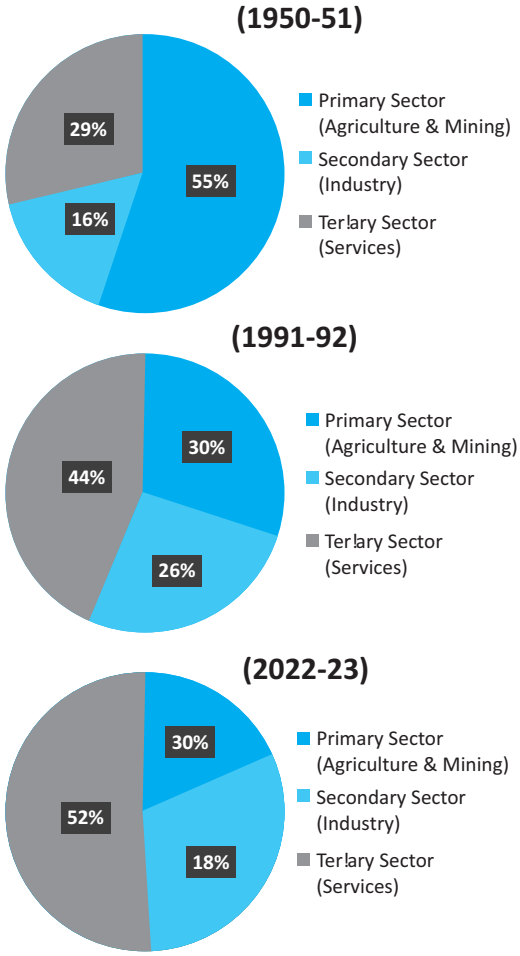


Fig. 2.2

DETERMINANTS OF NATIONAL INCOME

- **Aggregate Demand:** The total demand for goods and services in an economy influences production levels and hence national income. Higher demand leads to increased production and income.
- **Investment:** Capital expenditure by businesses on machinery, infrastructure, and technology contributes to economic growth, impacting national income positively.
- **Consumption:** Household spending on goods and services drives economic activity. Higher consumer spending generally results in increased production and, consequently, national income.
- **Government Spending:** Public expenditure on infrastructure, healthcare, education, and defence impacts economic growth and income levels.
- **Exports and Imports:** The balance of trade, i.e., the difference between exports and imports, affects national income. Higher exports contribute positively, while higher imports may have a negative impact.
- **Technology and Innovation:** Advancements in technology and innovation increase productivity and efficiency, boosting economic growth and national income.
- **Labor Force and Skills:** The size and quality of the workforce influence productivity. Education, training, and skill development enhance productivity levels and, consequently, national income.
- **Natural Resources:** Availability and utilisation of natural resources impact production capacities and can influence a country's national income.
- **Government Policies:** Fiscal and monetary policies implemented by the government, such as taxation, interest rates, and regulations, significantly influence economic activities and, consequently, national income.
- **Global Economic Conditions:** Factors like global trade, economic stability, geopolitical situations, and market demand also affect a country's national income by influencing exports, imports, and investments.

IMPORTANT CONCEPT UNDER NATIONAL INCOME

- **Domestic/Economic Territory Definition:** It represents the geographical area governed by the Indian Government, enabling the free circulation of individuals, goods, and capital within its boundaries. Foreign embassies within India are not considered part of this territory, whereas Indian embassies abroad are considered part of the domestic/economic territory.
  - **Inclusions in Domestic/Economic Territory:**
    - Military establishments, consulates, and embassies located in foreign countries are considered part of the domestic/economic territory.
    - Vehicles such as fishing vessels, ships, and aircraft operated by residents of the country are also included, even if they traverse foreign geographical or political boundaries.
  - **Consideration of Revenue and Profits:**
    - For instance, the revenues and profits generated by entities like Air India, operating internationally, are accounted for within India's Gross Domestic Product (GDP).
- **Market Price (MP):** Market Price refers to the current prevailing price at which goods, services, securities, or assets are bought or sold in an open market between buyers and sellers. It is the price that consumers are willing to pay and producers are willing to accept for a product or service, determined by the forces of supply and demand in the market.
- **Factor Cost (FC):** Factor Cost refers to the total expenses incurred by producers in the process of generating goods or services **before accounting for indirect taxes but including subsidies**.

- For example, if a company produces furniture, the factor cost will encompass expenses like raw materials, wages for labour, rent for manufacturing space, interest paid on capital, and other production-related costs. It excludes taxes levied on the production process but incorporates any subsidies received, providing a more direct view of the actual cost of production.

Factor Cost = Market Price - Net Indirect Taxes

Where Net Indirect Taxes = Indirect Taxes - Subsidies

- **Depreciation:** Depreciation is the reduction in the value of an asset over time due to wear and tear, obsolescence, or ageing. It reflects the decrease in the asset's worth or its usefulness over its useful life.
  - For instance, if a company owns machinery used in manufacturing, the wear and tear of that machinery over time causes a decline in its value. This decline, represented as depreciation, is accounted for annually in financial statements to accurately reflect the decreasing value of the machinery. Depreciation is crucial in assessing the true profitability of a business by factoring in the diminishing value of its assets.
- **Net Factor Income from Abroad (NFIA):** It refers to the difference between income earned by a country's residents from their investments or work abroad and the income earned by foreigners within the country.
  - For example, if a country's citizens or businesses own assets or investments in other countries and receive income from those investments (like profits, interest, or wages), that income is considered part of the country's NFIA. Conversely, income earned by foreign individuals or businesses within the country is deducted from the total to calculate the net factor income from abroad. NFIA is an essential component in determining a country's Gross National Income (GNI) from its Gross Domestic Product (GDP).

NFIA = Factor Income from Rest of the World - Factor Income to Rest of the World

- **Transfer Payments:** Transfer Payments refer to monetary transactions made without the expectation of receiving goods, services, or assets in return. These payments are typically made by governments, organisations, or individuals to redistribute income, provide aid, or support specific groups or regions.
  - For instance, government welfare programs, unemployment benefits, pensions, and subsidies to industries or individuals are examples of transfer payments. These payments aim to support those in need, redistribute income, or aid specific sectors, without any direct exchange of goods or services. They are meant to assist individuals or groups rather than to purchase goods or services in return.
  - **Note:** Transfer payments are not included in the National Income.
- **Net Domestic Product (NDP):**
  - NDP quantifies a nation's yearly economic output, considering depreciation.
  - It is calculated by subtracting depreciation from the Gross Domestic Product (GDP).
  - It reflects the net value of goods and services produced, accounting for the wear and tear or loss of value of capital goods.

Net Domestic Product (NDP) = Gross Domestic Product (GDP) - Depreciation

- **Gross National Product (GNP):**
  - GNP estimates the total value of all final products and services produced within a period by a country's residents.
  - It includes goods and services produced domestically and abroad by a country's citizens.
  - It indicates the overall economic output generated by a country's citizens, regardless of their location of production.

GNP = GDP + Net Factor Income from Abroad

- **Net National Product (NNP):**
  - NNP measures the monetary value of finished goods and services produced by a country's citizens, both within the country and overseas, within a specific timeframe.
  - It represents the net value of economic output generated by a country's citizens, considering depreciation or loss of value of assets.

NNP = GNP - Depreciation

- **National Disposable Income (NDI):**
  - It represents the maximum amount of goods and services available for domestic consumption.
  - NDI = Net National Product at Market Prices + Other Current Transfers from the Rest of the World.
  - **Note:** Other Current Transfers include gifts, aids, etc., received from abroad.

NDI = Net National Product at Market Prices + Other Current Transfers from the Rest of the World

- **Private Income:** It represents income received by the private sector.

Private Income = Factor income from Net Domestic Product accruing to the private sector (wages, salaries, profits) + National debt interest received by the private sector + Net factor income from abroad (difference between income earned by residents abroad and income earned by foreigners in the domestic economy) + Current transfers from government (pensions, scholarships, social security benefits) + Other net transfers from the rest of the world (excluding gifts and aids)

Understanding Personal Income and Disposable Income

- National Income (NI) represents the total income earned within an economy. However, not all of it goes directly to households. Let's break down the components that affect Personal Income (PI):
- **Undistributed Profits (UP):** A portion of the profits earned by firms and government enterprises is not distributed to households. This needs to be deducted from NI to calculate PI.
- **Corporate Tax:** Taxes levied on corporate income are not directly received by households and must be subtracted from NI to reach PI.
- **Net Interest Payments:** Households receive interest on loans they've provided to firms and the government. However, they also pay interest on borrowed funds. We need to consider the net interest payments (received minus paid) when calculating PI.
- **Transfer Payments:** Households receive various transfers from the government and firms (pensions, scholarships, prizes). These need to be added to NI to arrive at PI.
- **Therefore, PI = NI - UP - Net Interest Payments - Corporate Tax + Transfer Payments**

Personal Disposable Income (PDI)

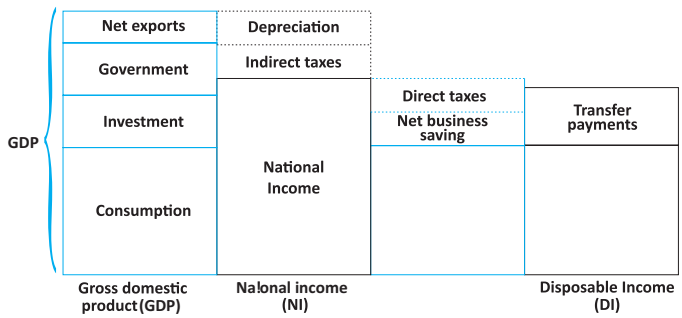
- It represents the income truly available to households for spending or saving. It is calculated by deducting further payments from PI:
- **Personal Tax Payments:** This includes income tax and other taxes levied directly on individual income.
- **Non-tax Payments:** This includes fines, fees, and other non-tax charges imposed on households.
- **Therefore, PDI = PI - Personal Tax Payments - Non-tax Payments**

Overall This Implies

- Personal Income represents the portion of National Income available to households after accounting for undistributed profits, taxes, net interest payments, and transfer payments.
- Personal Disposable Income further subtracts personal tax payments and non-tax payments, providing the income truly available to households for consumption and savings.

EIGHT KEY METRICS TO PROVIDE INSIGHTS INTO NATIONAL INCOME

- GDP_{MP} = Gross Domestic Product at Market Price.
- GDP_{FC} = Gross Domestic Product at Factor Cost
  = GDP_{MP} – Indirect taxes + Subsidies
- NDP_{MP} = Net Domestic Product at Market Price
  = GDP_{MP} – Depreciation
- NDP_{FC} = Net Domestic Product at Factor Cost
  = NDP_{MP} – Indirect taxes + Subsidies
- GNP_{MP} = Gross National Product at Market Price
  = GDP_{MP} + Net Factor Income from Abroad (NFIA)
- GNP_{FC} = Gross National Product at Factor Cost
  = GDP_{MP} – Indirect taxes + Subsidies + NFIA
- NNP_{MP} = Net National Product at Market Price
  = GDP_{MP} – Depreciation + NFIA
- NNP_{FC} (or National Income) = Net National Product at Factor Cost = GDP_{MP} – Depreciation + NFIA - Indirect taxes + Subsidies



Starting with GNP, we can calculate national income (NI) and disposable personal income (DI)

Fig. 2.3

Let us understand this through given below flowchart:

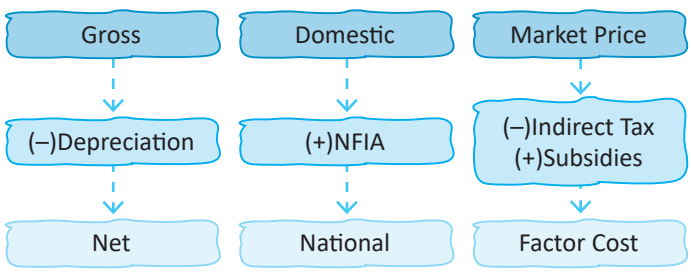


Fig. 2.4

Difference Between GDP, GNP and GNI

Feature	GDP (Gross Domestic Product)	GNP (Gross National Product)	GNI (Gross national Income)
Measurement	Total market value of final goods and services produced within a country's borders.	Total market value of final goods and services produced by residents of a country, regardless of location.	Total income earned by residents of a country, including income earned from abroad.
Focus	Production within a country's borders.	Production by residents of a country.	Income received by residents of a country.

Feature	GDP (Gross Domestic Product)	GNP (Gross National Product)	GNI (Gross national Income)
Components	Consumption + Investment + Government spending + Net exports.	Consumption + Investment + Government spending + Net factor income from abroad.	GDP + Net factor income from abroad.
Uses	Measuring economic activity within a country.	Comparing the economic performance of different countries.	Analysing the overall well-being of a country's residents.
Limitations	Ignores income earned by foreign companies operating in the country.	Does not include income earned by residents abroad.	May not fully capture the well-being of all residents if significant income inequality exists.

REAL VS NOMINAL GDP

Nominal GDP

- Nominal GDP signifies the total value of goods and services produced within an economy, determined by **current market prices**. It gauges economic activity based on prevailing market prices at the time of computation.
- Nominal GDP is derived by multiplying the quantities of goods and services produced by their respective prevailing market prices. The formula stands as:

Nominal GDP = Price of Goods and Services × Quantity of Goods and Services

Significance of Nominal GDP

- Reflects changes in both production and price levels, capturing the combined impact of quantity and price changes.
- Useful for assessing an economy's revenue and expenditure in present-day terms.
- Offers insights into nominal income levels within the economy.

Example:

- Imagine an economy that produces 50 bicycles priced at ₹600 each and 100 scooters priced at ₹8,000 each. Calculating the Nominal GDP:
- Nominal GDP = (50 bicycles * ₹600) + (100 scooters * ₹8,000) = ₹30,000 + ₹800,000 = ₹830,000

Real GDP

- **Definition of Real GDP:** Real GDP reflects an economy's production by adjusting nominal GDP for changes in price levels caused by inflation. It focuses exclusively on changes in the volume of goods and services produced.
- **Calculation Method:** Real GDP is computed using a chosen base year's prices as a reference. The quantities of goods and services produced in different years are multiplied by the base year's prices. The formula stands as:

Real GDP = Price in Base Year × Quantity of Goods and Services

- **Significance of Real GDP:**
  - Offers a clearer representation of production growth, removing the influence of price fluctuations.
  - Enables comparisons of economic performance across diverse time periods.
  - Provides insights into the actual expansion of an economy, irrespective of price changes.
- **Example:**
  - Suppose in the base year, the price of bicycles was ₹500 each, and scooters were ₹5,000 each. If the economy produced 200 bicycles and 50 scooters in a subsequent year, the Real GDP calculation would be:
  - Real GDP = (200 bicycles × ₹500) + (50 scooters × ₹5,000) = ₹150,000 + ₹250,000 = ₹400,000

Analyse the impact of inflation on the real and nominal values of national income. How can policymakers address the challenges posed by Inflation

- **Impact of Inflation on National Income:** Inflation has a significant impact on both the real and nominal values of national income. Understanding these impacts is crucial for formulating effective economic policies.
- **Impact on Nominal Value:**
  - **Increase:** Inflation directly increases the nominal value of national income. As prices rise, the value of all goods and services produced within the country increases, even if the quantity of output remains constant.
  - **Misleading:** This increase in nominal national income can be misleading, as it may not reflect a true increase in economic activity.
  - **Distortion of comparisons:** Comparing nominal national income across different periods with varying inflation levels can be inaccurate and lead to misinterpretations.
- **Impact on Real Value:**
  - **Decrease:** Inflation erodes the purchasing power of money, reducing the real value of national income. Even if the nominal national income increases, it may not translate into a proportional increase in the quantity of goods and services that can be purchased.
  - **Distortion of income distribution:** Inflation can disproportionately impact different income groups, potentially exacerbating income inequality.
  - **Uncertainty and instability:** High inflation can create uncertainty for businesses and investors, hindering economic growth and development.

- **Policy Measures to Address Inflation:**
  - **Monetary Policy:**
    - **Interest rate adjustments:** Central banks can increase interest rates to make borrowing more expensive and discourage spending, thereby reducing the money supply and inflationary pressures.
    - **Reserve requirements adjustments:** Central banks can increase reserve requirements for banks, requiring them to hold a larger portion of their deposits as reserves, reducing the amount of money available for lending and spending.
  - **Fiscal Policy:**
    - **Government spending adjustments:** Government can reduce its spending, particularly on non-essential items, to decrease aggregate demand and inflationary pressures.
    - **Taxation:** Implementing progressive tax policies can help to control inflation by reducing the disposable income of individuals with higher incomes, thereby decreasing aggregate demand.
  - **Supply-Side Policies:**
    - **Promoting competition:** Government policies can encourage competition in key sectors to reduce market power and price manipulation by businesses.
    - **Investing in infrastructure:** Investing in infrastructure can improve efficiency and productivity, leading to lower production costs and potentially reducing inflationary pressures.
    - **Trade policies:** Implementing trade policies that encourage imports and discourage exports can help to increase the supply of goods and services in the domestic market, reducing inflationary pressures.
  - **Income and Price Controls:**
    - **Price controls:** Direct government regulation of prices and wages can be implemented in exceptional circumstances to control inflation. However, these controls can have unintended consequences and distort market mechanisms.
    - **Income policies:** Government agreements with businesses and labour unions to limit wage and price increases can help to control inflation. However, these policies can also restrict economic growth and flexibility.

Comparative Analysis Between Real and Nominal GDP

Feature	Real GDP	Nominal GDP
Definition	Measures the actual volume of goods and services produced after adjusting for inflation	Measures the market value of goods and services at current prices.
Inflation-adjusted	Yes, uses a base year to compare production across different time periods.	No, reflects current prices without adjusting for inflation.
Focus	Production of goods and services.	Market value and price levels.
Benefits	Tracks actual economic growth.	Provides a current picture of the economy.
Limitations	Requires a base year and data adjustments.	Can be misleading due to inflation.
Applications	Comparing economic performance across time and countries.	Analysing current economic activity and its relationship with inflation and interest rates.

GDP Deflator

- The GDP deflator (also known as the implicit price deflator) is a measure of inflation for the entire economy. It is calculated by dividing nominal GDP (the total value of all final goods and services produced within a country in a year at current prices) by real GDP (the total value of all final goods and services produced within a country in a year at constant prices) and multiplying by 100.

GDP Deflator = Nominal GDP/Real GDP × 100

- In simpler terms, the GDP deflator tells us how much prices have changed on average for all goods and services produced in an economy over a specific period. A higher GDP deflator indicates higher inflation, while a lower GDP deflator indicates lower inflation.

Key Features of the GDP Deflator

- **It is a broad measure of inflation:** It captures price changes for all goods and services produced in the economy, making it a more comprehensive measure than other inflation indices like the Consumer Price Index (CPI), which focuses on specific categories of goods and services purchased by consumers.
- **It is a base-year relative:** The GDP deflator is expressed as a percentage of its value in a chosen base year. This allows for comparisons of inflation across different periods.
- **It reflects changes in both quantity and quality:** The GDP deflator accounts for changes in the quality of goods and services over time, making it a more accurate measure of inflation than some other indices.
- **It is used for various purposes:** The GDP deflator is used by policymakers to assess the effectiveness of economic policies, by businesses to make investment decisions, and by individuals to understand the impact of inflation on their purchasing power.

What is Base Year?

- In the context of measuring India's Gross Domestic Product (GDP), the base year is a reference point used to compare economic performance across different time periods.
- It represents a year where the prices of goods and services are assumed to be "normal" or "average," allowing economists to adjust for inflation and isolate the true growth in economic output.
- India currently uses 2011-12 as its base year for GDP calculations. This means that all GDP figures are expressed in terms of the prices prevailing in 2011-12, making it possible to compare economic growth between, say, 2015-16 and 2022-23, without the distorting effects of inflation.
- The base year is periodically changed to ensure the accuracy and relevance of the GDP data. Ideally, the base year should be updated every five years to reflect changes in the structure and composition of the economy.
- India's last base year change was in 2015, when it switched from **2004-05 to 2011-12**.

Why India Needed a New Base Year for National Accounts: Understanding The 2017-18 Revision

In the revised series, as is the practice internationally, industry-wise estimates are presented as Gross Value Added (GVA) at basic prices, while "GDP at market prices" will be referred to as "GDP". GDP at market prices, henceforth, be referred as GDP, can be computed by adding net of product tax and product subsidies in GVA at basic prices.

- Gross Value Added (GVA) at basic prices = Compensation of Employees + Operating Surplus + Mixed Income + Consumption of Fixed Capital (CFC) + Production taxes - Production subsidies
- GVA at factor cost (earlier referred to as GDP at factor cost) = GVA at basic prices - (Production taxes - Production subsidies)
- Gross Domestic Product (GDP) = GVA at basic prices + Product taxes - Product subsidies

The Dynamic Economy and the Need for Rebasing

- The structure of economic activities constantly evolves due to changes in production patterns, technology, and demand.
- These shifts require periodic adjustments to National Accounts Statistics to reflect the true size and structure of the economy.
- Rebasing exercises update base prices and incorporate new data sources, providing a fresh perspective on the economic landscape.

Key Improvements of the 2017-18 Revision

- **Comprehensive Coverage:** The new series includes data from the MCA 21 database and local bodies, leading to a more accurate picture of both corporate and unorganised sectors which previously was limited to RBIs Industrial outlook Survey and ASI annual data .
- **Shift to Enterprise Approach:** Moving away from establishment-based data, the new series captures the full range of activities undertaken by manufacturing companies, offering a more holistic view.
- **NSSO Surveys enhance Unorganized Sector Data:** Findings from recent National Sample Surveys improve the representation of unorganised sectors, often underrepresented in traditional data sources.
- **Focus on GVA:** Industry-wise estimates are now presented as Gross Value Added (GVA) at basic prices, providing insights into value creation within each sector.
- **Production & Product Taxes/Subsidies Differentiated:** The new series distinguishes between these categories, offering a clearer understanding of their impact on different sectors.

Impact on Data Interpretation

- Growth rates may differ compared to the old series due to the new base year and methodology.
- Some sectors, like manufacturing, might show higher value addition due to the inclusion of allied activities, while others might see lower GVA figures.
- The relative importance of various sectors in the economy may shift due to the improved coverage and changed data sources.

Understanding Potential GDP and its Relevance to India

Potential GDP represents the maximum output an economy can achieve when utilising all resources efficiently (labour, capital, technology) with full employment. It indicates the sustainable level of economic activity without inflation.

How Does it Relate to India?

India aims to achieve its full potential GDP and unlock its true economic potential. However, several factors contribute to the GDP Gap, the difference between potential and actual GDP. These factors include:

- **Gender Inequality:** Studies suggest that closing the gender gap in labour force participation could boost India's potential GDP by 27%. Promoting equal opportunities and empowering women to fully participate in the workforce is crucial.
- **Unemployment and Underemployment:** An active workforce is essential for economic growth. Addressing

issues like unemployment and underemployment through effective policies and skill development programs can significantly improve the utilisation of labour resources.

- **Technological Adoption:** Embracing new technologies and adopting innovative production methods are key to increasing efficiency and productivity. India needs to invest in research and development and encourage the adoption of advanced technologies in various sectors.
- **Regulatory Framework:** A streamlined and user-friendly regulatory framework can facilitate business operations and attract investments. Simplifying procedures and reducing bureaucratic hurdles can encourage entrepreneurship and drive economic activity.

Positive Developments

- The implementation of GST is estimated to have boosted India's potential GDP by 6.7% in five years, since its implementation. This reform has simplified the tax system and improved efficiency in the economy.
- The emergence of Artificial Intelligence (AI) holds immense potential for India. NASSCOM predicts that AI could add $450-$500 billion to the GDP by 2025. Investing in AI research and development can unlock significant economic benefits.

Methods of Calculating National Income (or GDP)

- **Production or Value-Added Method:**
  - This method, known as the Output Method or Value Added Method, estimates national income by analysing the value added in each economic sector.
  - It measures the difference between the total value of goods and services produced (output) and the value of goods and services used in production (intermediate consumption).
  - This provides a comprehensive picture of the economy's productive capacity.
  - It involves calculating the value of output minus the value of intermediate consumption at each stage of production across various sectors.
  - This method is commonly used in estimating GDP based on sector-wise contributions like agriculture, manufacturing, and services.
  - **Note: Intermediate consumption** refers to raw materials used in making final goods. This is subtracted while calculating Gross Value Added (GVA) to prevent counting the value of a product twice, once as a finished product and again as the materials used to create it.

(GVA or GDP)MP = Value of Output of all three sectors - Intermediate consumption of all three sectors

GVA vs. GDP: A Table of Key Differences

Features	GVA (Gross Value Added)	GDP (Gross Domestic Product)
Focus	Measures value added by each sector (agriculture, industry, services) at **each stage of production.**	Measures the total market value of all **final goods and services** produced in a country within a specific period.
Calculation	**GVA** = GDP - Net Factor Income (Income paid - Income received from abroad)	GDP = GVA + Net Taxes (Taxes earned - Subsidies provided)
Perspective	Provides a granular view of sectoral contributions to the economy.	Provides a broader view of overall economic performance.
Data Reference (2024 Q2)	India's GVA: 7.4% growth	India's GDP: 7.6% growth
Significance	Helps identify areas for sector-specific growth and assess the performance of individual industries.	Used for international comparisons and gauging overall economic activity.
Use cases	Policymakers use GVA to target interventions and track sectoral progress.	Investors and analysts use GDP to assess market potential and compare different economies.

- **Income Method:**
  - The Income Method calculates GDP by summing up all factor incomes earned within the economy.
  - It includes wages, profits, rent, and interest received by labour, capital, land, and entrepreneurship.
  - It measures economic activity by assessing income generated within the economy.
- **Components of National Domestic Product (NDP) at Factor Cost:**
  - **Compensation of Employees:**
    - Wages and salaries
    - Employer contributions to social security schemes
    - Dearness allowances
    - Other employee benefits
  - **Operating Surplus:**
    - Rent
    - Profit (including corporate tax, dividend, and undistributed profit)
    - Royalty
    - Interest

- **Mixed Income of Self-Employed:**
  - Earnings from farming enterprises
  - Income from sole proprietorships
  - Income from other professions like medical and legal practices
- **Note:** In self-employed professions, individuals act as entrepreneurs, financiers, workers, and landlords simultaneously, making it difficult to separate their income into distinct categories.

National Domestic Product (NDP) at Factor Cost = Compensation to Employees + Operating Surplus + Mixed Income of the Self-Employed.

- **Expenditure Method:**
  - The Expenditure Method estimates GDP by summing up all expenditures on final goods and services within the economy.
  - It includes four main components: Consumption (C), Investment (I), Government Spending (G), and Net Exports (NX).

The formula used is GDP = C + I + G + NX (where NX = Exports - Imports).

- It measures economic activity by considering spending from households, businesses, government, and foreign trade.
- **Note:** The Expenditure method is predominantly favoured due to the ready availability of necessary data it requires.

The Expenditure Method is Often Considered The Preferred Method Due To Several Advantages

- **Comprehensive:**
  - The expenditure method captures all final goods and services produced within a country, regardless of who produces them. This includes both goods and services sold in the market and those produced for self-consumption.
- **Data Availability:**
  - Data on expenditure, such as consumption, investment, government spending, and net exports, is often more readily available and reliable than data on production or income. This makes the expenditure method more practical to implement.
- **Consistency with Macro-economic Theories:**
  - The expenditure method aligns well with macroeconomic theories that emphasise aggregate demand as a key driver of economic activity. It provides a clear picture of how different components of expenditure contribute to national income.
- **Cross-Country Comparisons:**
  - The expenditure method allows for easier comparison of national income across different countries, as data collection and reporting standards are more standardised for expenditure data compared to production or income data.
- **Captures Informal Economy:**
  - The expenditure method can capture the economic contribution of the informal sector, which is often underrepresented in production and income data. This is because the expenditure method includes all final goods and services consumed, regardless of whether they are produced formally or informally.

Limitations of The Expenditure Method

- **Double Counting:**
  - There is a risk of double counting if intermediate goods are included in both investment and final consumption expenditures. This can lead to an overestimation of national income.
- **Data Accuracy:**
  - The accuracy of the expenditure method depends on the accuracy of data on various expenditure components. Inaccurate data can lead to inaccurate estimates of national income.
- **Difficulty in Estimating Net Exports:**
  - Estimating net exports can be challenging, particularly for countries with significant informal trade. Inaccurate estimates of net exports can affect the overall accuracy of national income estimates.

While no single method is perfect, the expenditure method offers several advantages over other methods for measuring national income. Its comprehensiveness, reliance on readily available data, consistency with macro-economic theories, and the ability to capture the informal economy makes it a preferred approach for many economists and policymakers.

Productivity, Capital Output Ratio (COR) and Incremental Capital Output Ratio (ICOR)

Productivity

Productivity refers to the output generated per unit of input. In the context of an economy, it can be measured as the ratio of Gross Domestic Product (GDP) to a specific input like labour, capital, or total factor inputs. Higher productivity implies greater efficiency in utilising resources to produce output.

- **Labour Productivity = GDP/Total Labour Hours**
- **Capital Productivity = GDP/Total Capital Stock**
- **Total Factor Productivity = GDP/(Labour + Capital)**

Importance of Productivity

- **Economic Growth:** Increased productivity fuels economic growth by enabling the production of more goods and services with the same amount of resources.
- **Standard of Living:** Higher productivity leads to increased wages and improved standards of living for the population.
- Global Competitiveness: Productivity plays a crucial role in a nation's competitiveness in the global market.

Example:

- **Labour Productivity:** It measures the efficiency of labour in generating output. For instance, if a factory produces 100 units of goods with 10 workers in a day, the labour productivity is 10 units per worker per day.
- **Capital Productivity:** This assesses the efficiency of capital (machinery, equipment, etc.) in generating output. For example, if a company invests $1 million in machinery and produces goods worth $2 million, the capital productivity is $2 output per $1 input.

Capital Output Ratio (COR)

COR measures the amount of capital required to generate one unit of output. It is calculated as the ratio of the capital stock to GDP. A lower COR indicates efficiency in capital utilisation, meaning less capital is needed to produce the same amount of output.

COR = Capital Stock / GDP

Significance of COR

- **Investment Efficiency:** A lower COR suggests that investments are being utilised effectively to generate output, leading to higher returns on investments.
- **Economic Development:** A declining COR over time indicates efficient capital allocation and potentially faster economic development.
- **Policy Implications:** COR influences policy decisions related to investment incentives, infrastructure development, and technological advancements.

Example: Suppose a company invests $10 million in machinery and produces goods worth $20 million. The COR would be calculated as $10 million (capital input) divided by $20 million (output), resulting in a COR of 0.5. This means that for every unit of output, the company requires half a unit of capital.

Incremental Capital Output Ratio (ICOR)

ICOR measures the additional capital required to generate a unit of additional output. It is calculated as the ratio of the increase in capital stock to the increase in GDP. A lower ICOR indicates that less additional capital is needed to achieve higher economic growth.

Formula

ICOR = (Δ Capital Stock) / (Δ GDP)

Relevance of ICOR

- **Planning and Budgeting:** ICOR helps policy makers estimate the amount of investment needed to achieve desired economic growth targets.
- **Efficiency of Investments:** A declining ICOR suggests efficient utilisation of investments for achieving higher growth, indicating a healthy economy.
- **Intersectoral Analysis:** ICOR can be used to compare the efficiency of capital utilisation across different sectors of the economy.

Example: If a company invests an additional $5 million in capital and this leads to an increase in output worth $10 million, the ICOR would be calculated as $5 million (incremental capital) divided by $10 million (incremental output), resulting in an ICOR of 0.5. This implies that the company requires half a unit of incremental capital to produce one additional unit of output.

Per Capita Income

- Per capita income refers to the average income earned by every person residing in the country in a given year. It represents the total national income divided by the total population.

Per Capita Income = National Income / Total Population

Significance

- Per capita income is a crucial indicator of the standard of living and economic well-being of a country's population. It provides insights into income distribution, wealth disparity, and the overall economic prosperity of the nation.

Limitations

- **Average figure:** It masks the significant income inequality within the population.
- **Does not account for non-monetary benefits:** It only considers income earned through monetary transactions, neglecting non-monetized benefits like access to healthcare and education.
- **Does not reflect cost of living:** It doesn't consider the differences in the cost of living across different regions within the country.

Year	1950-51	2011-12	2023
Per capita income of India in nominal terms	₹ 7513	₹ 63460	₹ 172000

LIMITATIONS IN THE MEASUREMENT OF NATIONAL INCOME

- **Lack of reliable data:**
  - India has a large informal sector, which makes it difficult to collect accurate data on income and production.
  - Additionally, many people are self-employed, and they may not keep accurate records of their income.
- **Double counting:**
  - Double counting occurs when the value of a good or service is included in national income more than once.
  - For example, the value of wheat may be counted when it is harvested, and then again when it is sold as flour.
- **Non-monetized activities:**
  - Many activities that contribute to the well-being of citizens are not included in national income because they are not monetized.

- For example, the value of housework and childcare is not included in national income.

- **Subjectivity in valuation:**
  - The value of some goods and services is difficult to measure accurately.
  - For example, the value of research and development or environmental services can be subjective.
- **Time lag:** There is often a time lag between the production of a good or service and the time it is included in national income.
- **Statistical errors:** There is always a margin of error involved in collecting and processing data.
- **Lack of comparability:** Different countries use different methods to measure national income. This can make it difficult to compare national income figures between countries.
- **National income at factor cost includes subsidy:** This means that the national income may be overestimated, as it includes the value of subsidies, which are not actually income received by producers.

Economic Survey of India 2023-24: Facts Related to National Income

- **Growth:**
  - GDP projected to grow 6.0% to 6.8% in FY24.
  - This represents a moderate slowdown from the estimated 7.0% growth in FY23.
  - The main drivers of growth are expected to be private consumption and investment.

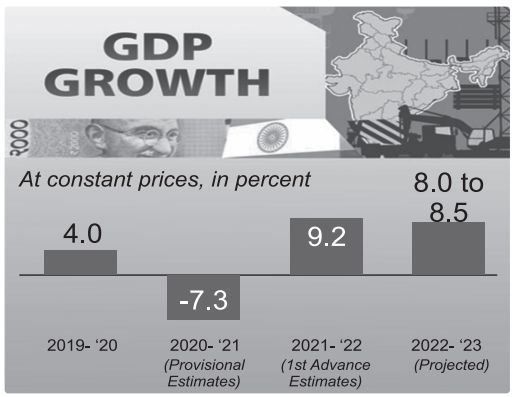


Fig. 2.5

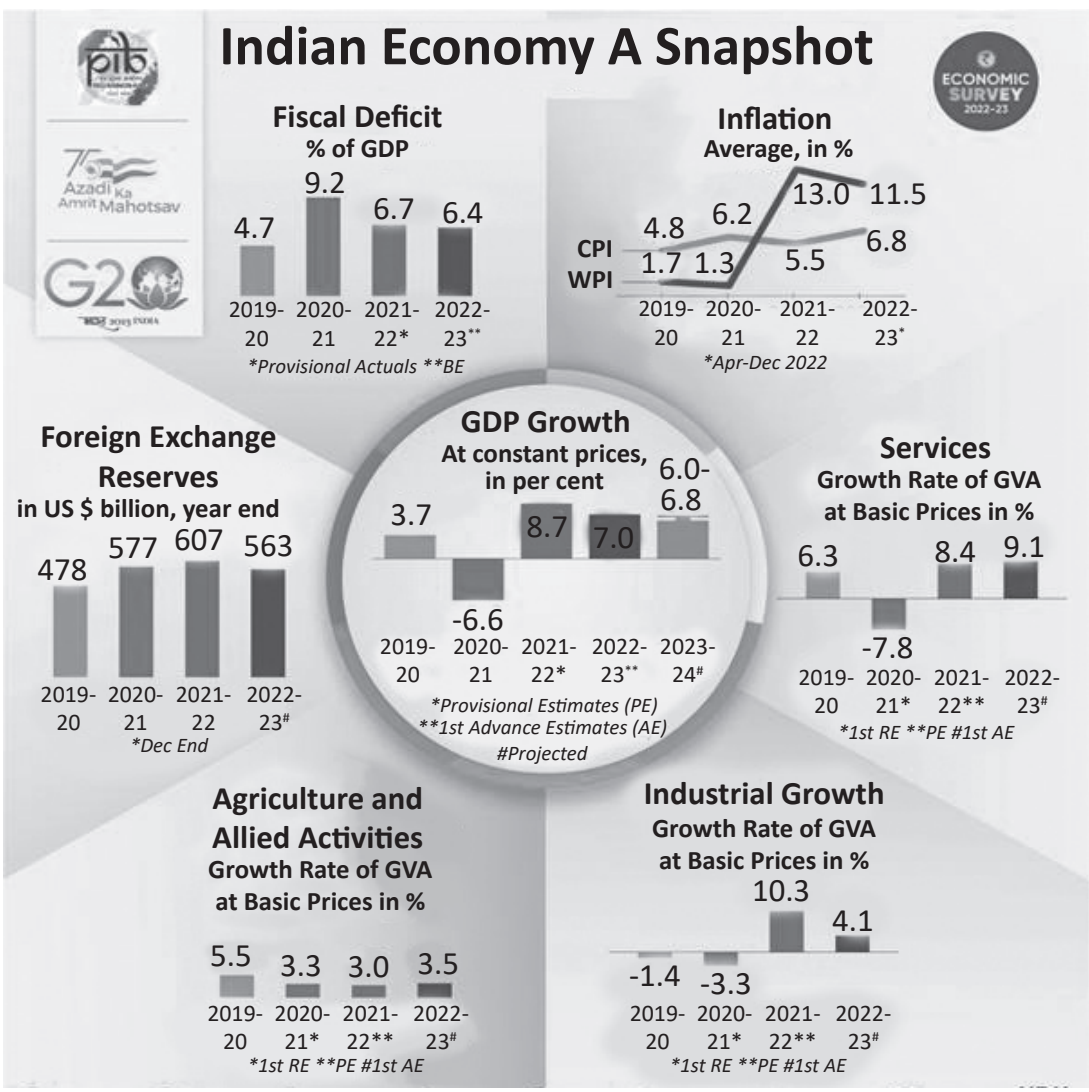


Fig. 2.6

- **Components:**
  - Private consumption is expected to grow by 6.7% in FY24.
  - This is supported by rising incomes, improving consumer confidence, and ongoing government stimulus measures.
  - Gross Fixed Capital Formation (GFCF) expected to grow by 7.5% in FY24.
  - This reflects an increase in private sector investment, particularly in infrastructure and manufacturing.
  - Government consumption is expected to grow 2.5% in FY24.
  - This is due to fiscal consolidation efforts by the government.
- **Gross Fixed Capital Formation (GFCF):**
  - Gross Fixed Capital Formation (GFCF) is a key economic indicator that measures the **amount of investment** in an economy during a specific period. It essentially represents the value of **new or used fixed assets** acquired by resident producers within a country. GFCF has following two components:
    - **Tangible assets:** It includes physical infrastructure like buildings, roads, machinery, and equipment.
    - **Intangible assets:** It can encompass intellectual property like software, research and development (R&D) expenditure, and creative design works.
- **Employment:**
  - Urban unemployment rate is expected to decline to 7.0% in FY24.
  - This is lower than the 7.8% estimated for FY23.
  - Employment generation is expected to be driven by the services sector.
- **Inflation:**
  - Retail inflation is expected to average 5.0% in FY24.
  - This is within the Reserve Bank of India's (RBI) target range of 2-6%.
  - Food inflation is expected to remain moderate, while core inflation may pick up slightly.

Green GDP: Measuring Economic Growth with Environmental Impact

Growth Rate of Indian Economy: Sector Wise

Green Gross Domestic Product (GGDP) is a modified version of traditional GDP that incorporates the environmental cost of economic activity. It aims to provide a more holistic measure of economic progress by accounting for the depletion of natural resources and environmental degradation.

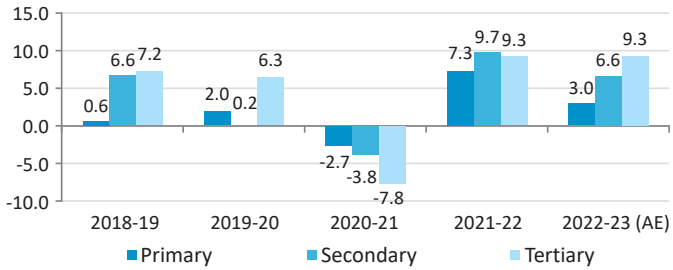


Fig. 2.7

Calculating Green GDP

- Traditional GDP measures the total value of goods and services produced in an economy.
- GGDP starts with GDP and then deducts the following environmental costs:
  - **Depletion of natural resources:** This includes the extraction of minerals, fossil fuels, and timber.
  - **Environmental degradation:** This includes air and water pollution, deforestation, and soil erosion.
  - **Costs of climate change:** This includes future economic losses due to rising sea levels, extreme weather events, and other impacts of climate change.

Current Data and Insights

- **Global estimates:** A 2020 study found that global GGDP was about 24% lower than traditional GDP in 2016, highlighting the significant environmental cost of economic activity.

Country Examples

- **India:** A 2022 report by the Reserve Bank of India estimated India's GGDP for 2019 at about Rs 167 trillion, which was 3% lower than its traditional GDP.
- **China:** A 2021 study found that China's GGDP was about 15% lower than its traditional GDP in 2019.

Significance of GGDP

- **Provides a more complete picture of economic performance:** By accounting for environmental costs, GGDP gives a more realistic assessment of economic progress.
- **Informs policy decisions:** GGDP can help policy-makers to develop strategies for addressing the environmental challenges and to promote sustainable economic growth.
- **Raises awareness about environmental impact:** By highlighting the hidden costs of economic activity, GGDP can encourage businesses and individuals to reduce their environmental footprint.

Challenges and Limitations

- **Data availability:** Measuring environmental costs accurately can be difficult due to limited data and complex methodologies.

- **Valuation methods:** There are different approaches to valuing environmental costs, leading to variations in GGDP estimates.
- **Policy integration:** Integrating GGDP into economic decision-making requires a fundamental shift in thinking and policy frameworks.

CAN GDP ALWAYS BE COUNTED AS A MEASURE OF WELFARE STATE?

- While GDP is often used as an indicator of welfare, it has certain limitations:
  - **Distribution of GDP:**
    - GDP growth may not translate to increased welfare if wealth is concentrated among a few.
    - Even with rising GDP, many individuals may experience lower incomes, leading to reduced well-being for a large portion of the population.
  - **Non-monetary exchanges:**
    - Activities outside the formal market, such as domestic services and barter exchanges, are not included in GDP.
    - This underestimates the actual economic activity and well-being, particularly in developing countries with significant informal sectors.
  - **Externalities:**
    - Unpriced benefits or harms caused by firms or individuals (externalities) are not reflected in GDP.
    - Negative externalities, like pollution, can decrease welfare despite higher GDP, while positive externalities contribute to welfare but go uncounted.

CONCLUSION

National Income measures a nation's annual economic output, assessing goods and services produced within a year. It's vital for policy-making and gauging economic well-being. Calculated through GDP variants, India's history in estimation has evolved, relying on methods like production, expenditure, and income. Challenges in accuracy persist due to double counting, informal sectors, and data reliability. Despite limitations, per capita income growth and economic surveys provide crucial insights into India's economic journey, aiding policy adjustments and resource planning.

Poverty, Inequality and Unemployment

3

"Poverty is not created by some natural or physical necessity. It is created by our economic and social arrangements."

Amartya Sen (Development as Freedom, 1999)

POVERTY

According to the **World Bank**, poverty is **"pronounced deprivation in well-being."** This definition encompasses not only a lack of income or resources, but also the inability to meet basic needs and enjoy essential living standards.

In India, the commonly acknowledged definition of poverty tends to underscore the notion of a **minimum level of living** rather than a more equitable and reasonable standard of living. This perspective highlights a focus on addressing the basic necessities required for survival, but it may fall short of encompassing the broader aspects of a dignified and satisfactory quality of life for all.

Formerly, the **Planning Commission** was responsible for releasing poverty estimates derived from different rounds conducted by the National Sample Survey Office (NSSO), focusing on monthly per capita consumption expenditure.

Currently, **NITI Aayog** uses the data collected by the **National Sample Survey Office (NSSO) under the Ministry of Statistics and Programme Implementation (MOSPI)** to calculate the **poverty line for both rural and urban areas**.

- The **IBSA Trust Fund Agreement**, aimed at combating poverty in developing nations, was signed by **India, Brazil, and South Africa** during the 8th IBSA Trilateral Ministerial Commission Meeting in Durban (2017).
- Under this agreement, each participating country pledges an annual contribution of **1 million USD** to the fund, which is overseen by the Special Unit for South-South Cooperation within the UN Development Programmer (UNDP).
- The IBSA Dialogue Forum, established to foster international collaboration among India, Brazil, and South Africa, was formalized with the adoption of the "Brasilia Declaration" in 2003

CONCEPT OF POVERTY

In the realm of development literature, poverty is characterized as 'multi-dimensional.'

This entails measurement not solely based on income deficiency but also encompassing fundamental necessities like health, education, nutrition, and shelter. A more comprehensive perspective on poverty extends to social security and empowerment. Both **income and non-income facets** of poverty contribute to gauging whether an individual is leading a dignified and respectful life.

This broader definition, endorsed by **UNDP** in the 'Human Development Report' and the **World Bank** in the 'World Development Report,' delineates poverty as a human condition marked by sustained or chronic deprivation of resources, capabilities, choices, security, and power essential for enjoying an adequate standard of living and other rights encompassing civil, cultural, economic, political, and social aspects (UN, 2001).

Nobel Laureate **Prof Amartya Sen** further expounds on the **broader approach to poverty**. In societies where individuals lack capability—such as insufficient income, poor health, low self-confidence, or powerlessness—poverty emerges. Sen's definition emphasizes the root cause of poverty as a **deficiency in capability** rather than solely focusing on low income.

Occasionally, poverty is defined through a '**human rights approach**,' framing it as a violation of economic, political, social, and civil rights. These rights encompass entitlements like the right to education, right to minimum health standards, right to a decent living, and right to employment. Upholding these rights ensures that individuals surpass a minimum threshold of capability.

IDENTIFYING THE POOR: STRATEGIES AND CATEGORIES

Eradicating poverty in India requires not just impactful solutions but also accurate identification of the impoverished population. This crucial task hinges on a well-defined poverty scale, carefully crafted by considering relevant criteria.

India has actively pursued various initiatives to quantify poverty. The Planning Commission, established in 1950, played a key role. In 1962, it set up as a Study Group, followed by the **"Task Force on Projections of Minimum Needs and Effective Consumption Demand"** in 1979. Further Expert Groups in 1989 and 2005 solidified the government's commitment to accurate poverty identification.

Beyond institutional efforts, individual economists have also contributed to this critical endeavor. Their work has helped categorize the population into "poor" and "non-poor," forming a spectrum from the most vulnerable to the affluent.

Accurately identifying the poor is crucial for multiple reasons:

- It ensures targeted interventions reach the most vulnerable, maximizing the impact of poverty alleviation programs.
- It provides valuable data for policy formulation, enabling the government to tailor solutions to specific needs.
- It fosters transparency and accountability, allowing for better monitoring and evaluation of progress.

Moving forward, India's approach to poverty identification must evolve to address contemporary challenges:

- **Incorporate multidimensional factors:** Beyond income, consider factors like access to education, healthcare, and sanitation to capture the full picture of poverty.
- **Embrace dynamic measurements:** Regularly update the poverty line to reflect changing prices, living costs, and social realities.
- **Leverage technology:** Utilize data analytics and digital infrastructure to improve the accuracy and efficiency of poverty identification.

By embracing a **data-driven, multi-faceted approach** to poverty identification, India can effectively target its efforts, maximize the impact of its interventions, and move closer to a future where poverty is not a defining reality for millions.

Categorizing Poverty

- **Chronic Poor:**Individuals consistently impoverished, including those who may occasionally have slightly more funds (e.g. casual workers).

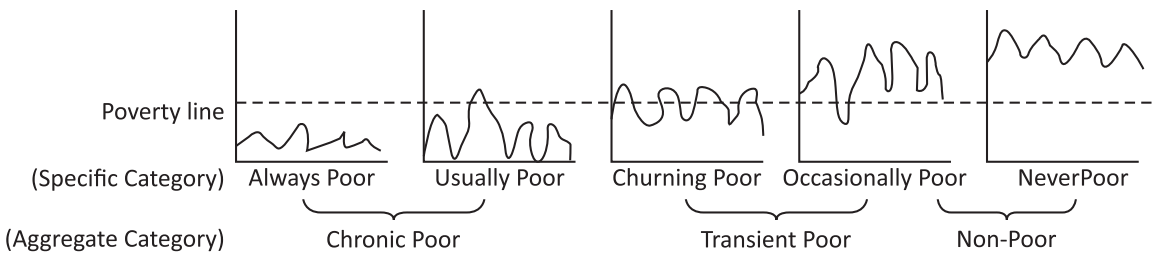


Fig. 3.1: The Chronic Poor, Transient Poor and Non-Poor

- **Churning Poor:** Individuals regularly moving in and out of poverty, exemplified by small farmers and seasonal workers.
- **Occasionally Poor (Transient Poor):** Individuals predominantly affluent but occasionally facing financial hardships.
- **Non-Poor:** Individuals who are never in a state of poverty.

CAUSES OF POVERTY IN INDIA

India's battle against poverty is multifaceted, demanding a nuanced understanding of the interplay between various factors. Let's delve into each layer with data-driven support:

Institutional and Social Factors

- **Limited Education and Skills:** Only 51.3% of India's population aged 25 and above have completed secondary education (UNESCO, 2022). This lack of education limits skill development and traps individuals in low-wage jobs.
- **Healthcare Access Gaps:** India's out-of-pocket healthcare expenditure, at 47.1% (7th National Health Account, 2019-20), significantly burdens the poor.
- **Discriminatory Barriers:** Caste-based discrimination continues to limit opportunities for marginalized groups, with Dalits experiencing 11% lower wages than non-Dalits (World Bank, 2020).
- **Unequal Playing Field:** India's Gini coefficient, a measure of income inequality, stands at 0.35 (World Bank, 2023), indicating significant wealth inequality. This translates to the top 10% of earners controlling 51% of the national income (IMF, 2022).
- **Unemployment and Underemployment:** India's unemployment rate in 2022 was 7.8% (World Bank, 2022), but underemployment remains a significant challenge, with 37% of employed individuals working less than their desired hours (ILO, 2023).
- **Debt Traps:** Household debt in India has risen rapidly, with 77% of rural households and 55% of urban households reporting debt (CMIE, 2022). This high debt burden can trap families in poverty.

Economic Factors

- **Low Capital Formation:** India's gross fixed capital formation as a percentage of GDP has been declining, reaching 29% in 2022 (World Bank). This lack of investment hinders economic growth and job creation.
- **Inadequate Infrastructure:** India ranks 38th in the World Bank's Logistics Performance Index (2023), highlighting infrastructure challenges that impede economic activity and market access.
- **Lack of Safety Nets:** India's social safety net programs are fragmented and inadequate, leaving many vulnerable to poverty shocks like illness or crop failure.
- **Sectoral Reliance:** 45% of India's workforce is employed in the agriculture sector, which is characterized by low productivity and income volatility (NITI Aayog).

Historical Factors

- **Colonial Legacy:** British colonial policies led to de-industrialization and resource exploitation, contributing to India's current economic structure and inequalities.
- **Unequal Land Ownership:** The concentration of land ownership in the hands of a few persists, with 68% of rural households being landless or marginal farmers (World Bank, 2018). This legacy of land reforms failures leaves many with limited economic opportunities.
- **Limited Agricultural Productivity:** Low agricultural productivity, often due to factors like fragmented landholdings and insufficient access to technology, hinders income growth for small farmers.

Additional Factors

- **Precarious Work:** The prevalence of informal and casual employment, estimated at 81% of non-agricultural jobs (ILO, 2018), deprives many of stable income and benefits.
- **Rising Prices:** Inflationary pressures, particularly for essential goods like food, disproportionately impact the poor as they spend a larger portion of their income on basic necessities.
- **Unequal Distribution of Resources:** Access to land, education, healthcare, and other resources remains unevenly distributed, perpetuating poverty cycles.
- **Pandemic Impact:** The COVID-19 pandemic disproportionately affected the poorest, with job losses and income declines further exacerbating existing vulnerabilities.

Understanding these data-driven insights is crucial for designing effective interventions and breaking the cycle of poverty in India. Investing in human capital, promoting inclusive economic growth, strengthening social safety nets, and addressing institutional inequalities are essential steps towards a more equitable and prosperous future for all.

Poverty is a complex issue with multiple causes. Addressing it requires a comprehensive approach that tackles both immediate needs and long-term challenges

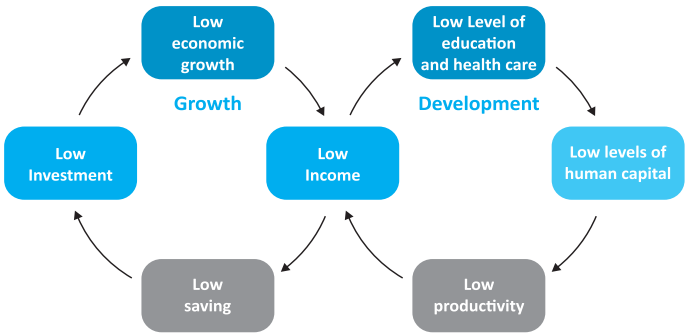


Fig. 3.2: Vicious Cycle of Poverty

POVERTY CLASSIFICATION

Absolute Poverty

- It is a condition which occurs due to deprivation from basic human needs such as food, clothing, health, education, sanitation facilities, shelter, etc.
- It is measured through the concept of poverty line and refers to the actual number of people living Below Poverty Line (BPL).

Approaches to Assess Absolute Poverty

- **Determining the Poverty Line**
  - The poverty line signifies the essential income level necessary to meet basic life requirements.
  - It can be expressed in terms of per capita calorie intake or per capita consumption expenditure, essential for achieving a minimum living standard.
  - Variations in the poverty line may exist between countries and even within different states of India, owing to varying price levels prevalent in each region.
- **Head count ratio(HCR) / Poverty incidence ratio**
  - Head count ratio (HCR), also known as the poverty incidence ratio is used in measuring poverty prevalence and signifies the percentage of individuals residing below the poverty line. The head count ratio (HCR) is the population proportion that exists, or lives, below the poverty threshold. One of the undesirable features of the head count ratio is that it ignores the depth of poverty; if the poor become poorer, the head count index does not change.
  - The formula for HCR is expressed as the ratio of the total number of people living in poverty to the overall population, multiplied by 100.

A previous world bank report indicated that India's poverty HCR reached a maximum of 61.6% in 1977. However, as per the latest report it is 14.95%(NITI Aayog 2019-21).

- **Poverty Gap Ratio (Measuring Intensity of Poverty)**
  - The Poverty Gap Ratio assesses the intensity of poverty and is defined as the variance between the poverty line and the average actual monthly consumption expenditure of a Below Poverty Line (BPL) household.
  - This ratio quantifies the average deficit from the poverty line and is mathematically expressed as the difference between the poverty line in monetary terms and the average actual monthly consumption expenditure per capita of a BPL household, divided by the poverty line. **For instance**, if the poverty line is Rs. 400 and the average actual monthly consumption expenditure is Rs. 330, the Poverty Gap Ratio would be (400 - 330) / 400 = 0.175, indicating a gap of 17.5 percent.
  - This metric enables the government to determine the per capita amount of transfers needed to eradicate poverty, potentially through precisely targeted cash transfers. A higher poverty gap implies a greater need for government transfers to lift BPL households above the poverty line.
- **Squared Poverty Gap Index**
  - The Squared Poverty Gap Index gauges the **severity of poverty in a specific area.**

- This approach involves squaring the poverty gap for each individual or household.
- BPL individuals experiencing larger shortfalls from the poverty line are given more significant weight than those falling only slightly short.
- The Squared Poverty Gap Index is particularly advantageous for individuals significantly below the poverty line, as it results in a higher aid amount from the government.

MULTIDIMENSIONAL POVERTY INDEX

- It represents a more comprehensive perspective, asserting that poverty is not solely reliant on income but also encompasses various deprivations, such as substandard health, limited access to education, and an inadequate standard of living.
- These deprivations are assessed at both the household and individual levels. The Multidimensional Poverty Index (MPI) offers a distinct approach to measuring 'acute' poverty by considering overlapping deprivations, deviating from the World Bank's measure of extreme poverty, which focuses on those living on less than $1.90 per day. The concept of MPI was collaboratively developed by the **UN Development Programme (UNDP) and OPHI (Oxford Poverty and Human Development Initiative)** and **was first introduced in 2010.**
- MPI replaces the Human Poverty Index, departing from the emphasis on income. Instead, MPI employs **three dimensions with 10 indicators** to measure absolute poverty. The specifics of these **three dimensions (Education, Health and Standard of Living)** and the associated 10 indicators under MPI are detailed below.

Dimensions of poverty and indicator	Condition for treating it	Related SDG	Weight area related to the dimensions of poverty
Education Years of schooling	Deprived if no family member (≥10 years of age) has completed 6 years of schooling	SDG 4 (Quality Education)	1/6th
Education School attendance	Deprived if any school-aged child is not attending school up to class VIII	SDG 4 (Quality Education)	1/6th
Health Child mortality	Deprived if any child of the family has died in the past 5 years	SDG 3 (Health and Well-Being)	1/6th
Health Nutrition	Deprived if any adult (under 70 years of age) or child is stunted	SDG 2 (Zero Hunger)	1/6th
Standard of Living Electricity	Deprived if no electricity	SDG 7 (Affordable and Clean Energy)	1/18th
Standard of Living Sanitation	Deprived if sanitation facility not improved as per Sustainable Development Goals (SDGs) guidelines or it is improved but shared with other households	SDG 6 (Clean Water and Sanitation)	1/18th
Standard of Living Drinking water	Deprived if does not have safe drinking water as per SDGs guidelines or it is a 30-minute walk (round trip) from home	SDG 6 (Clean Water and Sanitation)	1/18th
Standard of Living Housing	Deprived if does not have adequate housing material for one roof, walls and floor and/or made up of natural materials	SDG 11 (Sustainable Cities and Communities)	1/18th
Standard of Living Cooking fuel	Deprived if cooks with dung, wood, charcoal or coal	SDG 7 (Affordable and Clean Energy)	1/18th
Standard of Living Assets	Deprived if household doesn't own any of these - radio, TV, telephone, computer, animal cart, bicycle, motor, bike or refrigerator and does not own a car or truck	SDG 1 (No Poverty)	1/18th

- A person is considered multidimensionally poor if he/she is deprived in at least one-third of the weighted indicators shown above; in other words, **the cut-off for poverty is 33.33 percent.**

Key Findings of MPI 2023

Global Reduction in MPI Values

The report reveals that **25 nations, including India**, have successfully halved their global Multidimensional Poverty Index (MPI) values within a span of 15 years.

- **India-Specific Data:**
  - The latest update of the global MPI indicates that from **2005-06 to 2019-21**, a remarkable **415 million** people in India were lifted **out of poverty**.
  - The report emphasizes that deprivation across all indicators has diminished in India, with the poorest states and groups, including children and individuals from disadvantaged caste groups, experiencing the fastest absolute progress.

Global Poverty Statistics

As per the 2023 release, over 1.1 billion people, slightly more than 18% of the global population across 110 countries, live in acute multidimensional poverty.

India's Achievements and Social Development Schemes

The report acknowledges that India's success in poverty reduction can be attributed to some extent to the social development schemes implemented by the current government. Despite criticisms of rapid economic expansion not benefiting the poor, these estimates suggest that fast growth is indeed positively impacting the lives of the most disadvantaged.

While indications of the pandemic potentially reversing poverty reduction exist, the lack of adequate data cautions against drawing conclusive statements. Therefore, India's dedicated efforts in direct poverty relief must persist alongside the pursuit of economic growth.

NATIONAL MULTIDIMENSIONAL POVERTY INDEX (MPI)

The NITI Aayog has released the second edition of the Multidimensional Poverty Index under the title **'National Multidimensional Poverty Index: A Progress Review 2023**.' A country's national MPI statistic is customised to its priorities, allowing nations to select dimensions, indicators, weights, and cut-offs that align with their specific plans and contexts.

Central to India's priorities is the Sustainable Development Goal (SDG) target 1, which carries a robust mandate to reduce poverty in all its manifestations by at least 50% by the year 2030.

According to NITI Aayog, the government's concentrated efforts in enhancing accessibility to sanitation, nutrition, cooking fuel, financial inclusion, drinking water, and electricity have resulted in notable progress in these domains. The statement also highlights that strides in nutrition, educational attainment, sanitation, and access to cooking fuel have played a pivotal role in reducing poverty.

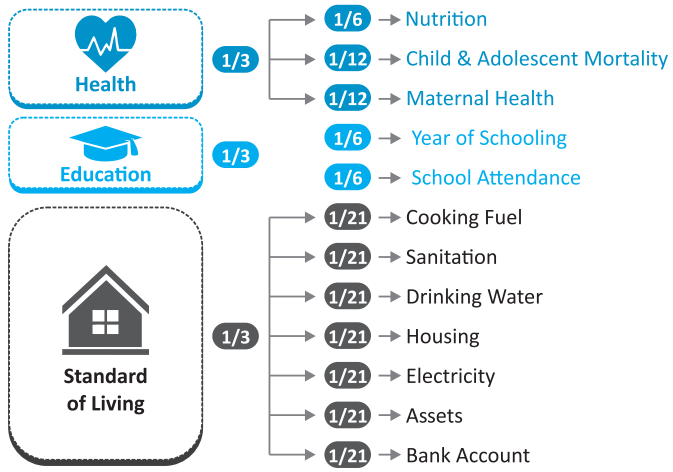


Fig. 3.3: Indicators and their weights

Approaches for Absolute Poverty Estimation

- **Uniform Reference/Recall Period (URP):**

  Until 1993-94, the National Sample Survey Office (NSSO) based its poverty line estimation on the URP method. This technique involves collecting consumption data for all items over a 30-day recall period. Households are surveyed about their consumption in the 30 days preceding the survey date.

- **Mixed Reference/Recall Period (MRP):**

  From 1993-94, NSSO shifted to using MRP instead of URP. MRP considers consumption expenditure for five non-food items (clothing, footwear, durable goods, education, and institutional medical expenses) over a 365-day recall period, while data for all other items are collected for a 30-day recall period. Presently, all poverty line estimates employ the MRP method.

- **Modified Mixed Reference/Recall Period (MMRP):**

  MMRP, the most recent concept among the three, incorporates varying recall periods for different categories. It utilises a 365-day recall period for certain items like clothing, footwear, education, institutional medical care, and durable goods. Edible oil, egg, fish and meat, vegetables, fruits, spices, beverages, refreshments, processed food, paan, tobacco, and intoxicants have a 7-day recall period. The remaining food items, fuel and light, miscellaneous goods and services, including non-institutional medical, rents, and taxes, are assessed over a 30-day recall period. NSSO applied the MMRP method to compute poverty for the years 2009-10 and 2010-11.

Differences between Income-Based and Consumption Expenditure-Based Poverty Lines

The NSSO suggests that relying on a poverty line determined by consumption expenditure is more effective than an income-based poverty line due to the following factors:

- **Income Stability:** A significant number of households in the informal sector experience irregular income, while their consumption patterns remain relatively stable.
- **Feasibility of Computation:** The use of URP, MRP, or MMRP may present challenges when calculating an income-based poverty line, making the consumption expenditure approach more practical.

The **Rangarajan Committee's 2014 report** recommended MMRP as a more suitable method for poverty measurement compared to URP and MRP methods. Additionally, in 2015, the **World Bank** advocated the transition from MRP to MMRP.

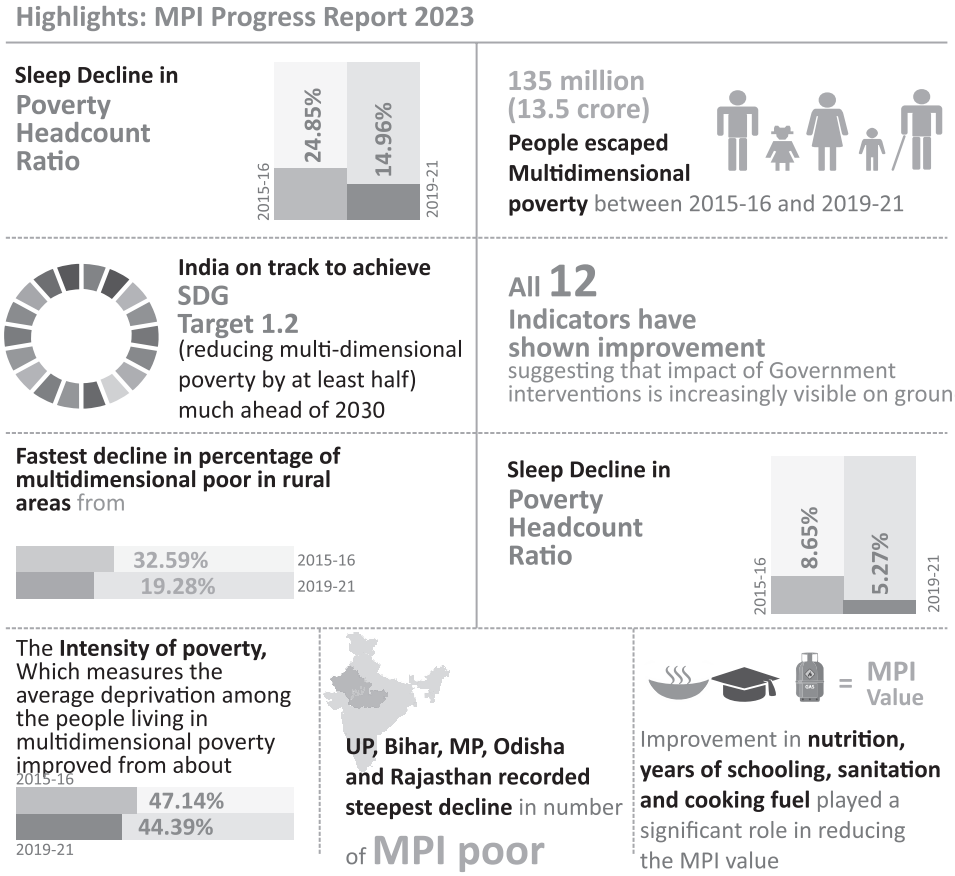

Highlights: MPI Progress Report 2023
Sleep Decline in Poverty Headcount Ratio
2015-16
24.85%
14.96%
2019-21
135 million (13.5 crore) People escaped Multidimensional poverty between 2015-16 and 2019-21
India on track to achieve SDG Target 1.2 (reducing multi-dimensional poverty by at least half) much ahead of 2030
All 12 Indicators have shown improvement
suggesting that impact of Government interventions is increasingly visible on ground
Fastest decline in percentage of multidimensional poor in rural areas from
32.59%
2015-16
19.28%
2019-21
Sleep Decline in Poverty Headcount Ratio
2015-16
8.65%
5.27%
2019-21
The Intensity of poverty, Which measures the average deprivation among the people living in multidimensional poverty improved from about
2015-16
47.14%
44.39%
2019-21
UP, Bihar, MP, Odisha and Rajasthan recorded steepest decline in number of MPI poor
= MPI Value
Improvement in nutrition, years of schooling, sanitation and cooking fuel played a significant role in reducing the MPI value

Fig. 3.4: Highlights: MPI Progress Report 2023

Comparative Analysis of Methods

URP	MRP	GNI (Gross National Income)
Poverty estimate will be highest compared to MMRP and MRP	Poverty estimate will be higher than MMRP but lower than URP	Poverty estimate will be lower than URP and MRP

MEASURES USED TO ESTIMATE POVERTY

An Adjustment to Global Poverty Lines

The World Bank Updated The Global Poverty Lines in September 2022

The new international poverty line is set at **$2.15 using 2017 prices** , which replaces the $1.90 poverty line, based on 2017 PPPs. This means that anyone living on less than $2.15 a day is considered to be living in extreme poverty. About **648 million** people globally were in this situation in 2019.

Multidimensional Poverty Measures

There are many **non-monetary indicators**—on education, health, sanitation, water, electricity, etc—that are extremely important for understanding the many dimensions of poverty that people experience. These are an important complement to monetary measures of poverty and are crucial to effectively improving the lives of the poorest. The **World Bank** has therefore introduced the **multidimensional poverty measure (MPM)**, which incorporates both monetary and non-monetary dimensions of poverty.

POVERTY ESTIMATION IN INDIA

In India we have a long history of studies on the measurement of poverty

Estimates before Independence

- The initial assessment of poverty was conducted by Shri Dadabhai Naoroji in his work titled **"Poverty and the Unbritish Rule in India."** Naoroji established subsistence levels, framing the poverty range from 16 to 35 per capita per year at 1867-68 prices. It's noteworthy that he didn't employ the term 'poverty line' but instead referred to it as a 'subsistence-based poverty line.'
- In 1938, the National Planning Committee, under the leadership of Shri J.L. Nehru, identified an irreducible minimum income falling within the range of ₹15 to ₹25 per capita per month at pre-war prices. However, this was not officially designated as the poverty line for the entire country.

Post-independence Estimates

Committee	Data Based on	Estimates of Poverty (HCR) (percentage)
B.S. Minhas's Study (in the 1950s)	1956-57	65
M.S. Ahluwalia's Study (in the 1960s)	1960-61	39
P.D. Ojha's Estimate (in the 1960s)	1960-61	44
P.K. Bardhan's Study (in the 1960s)	1968-69	54

Each of these four committees utilised identical data sources for their investigations, yet variations in their poverty estimates arose from the diverse methodologies they employed.

- In **1971**, the **Dandekar-Rath Committee** investigated poverty in India based on **1960-61 data**. They determined that a minimum of 2,250 calories per person per day was needed for adequate nutrition, and calculated the monetary cost of this **"Minimum Consumption Line."** Using this measure, they estimated that **40%** of the **rural population** and **50%** of the **urban population** lived below the poverty line. This **study significantly influenced India's understanding and measurement of poverty**.
- The **Y.K. Alagh Task Force**, formed in 1977, **defined poverty based on how much food people ate**. They said a person in the countryside needed 2,400 calories a day and someone in a city needed 2,100 calories to not be considered poor. This was because they thought people in the countryside did harder work. They didn't consider health or education when deciding if someone was poor, believing the government would take care of those things.

Committees	**D.T. Lakdawala Committee** (constituted in 1989 and submitted report in 1993)	**Suresh Tendulkar Committee (2005-2009)**	**Rangarajan Committee** Established in 2012 (Report Submitted: 2014)
Data used	**1973-74**	**2004-05**	**2011-12**
Method used	❑ Employed per capita consumption expenditure based on calorie intake, specifically 2,400 for rural regions and 2,100 for urban areas. ❑ URP was used to collect data ❑ Committee recommended for state specific poverty line ❑ According to the report, the poverty line will be revised based on the Consumer Price Index (CPI) for Agricultural Labor in rural regions and the CPI for Industrial Workers in urban areas.	❑ Adopted the urban poverty line of 2004-05 based on the Lakdawala methodology. ❑ Converted the poverty line from Urban Reference Person (URP) to Mixed Reference Person (MRP) consumption. ❑ Considered private expenditure on health and education. ❑ Used a uniform urban poverty line basket for both rural and urban areas.	❑ Separate estimates for rural and urban poverty ❑ Considered food and non-food expenditures ❑ Used Minimum Monthly Per Capita Expenditure (MMPCE) instead of Minimum Retail Price (MRP) ❑ Based on monthly expenditure of a family of five ❑ Took all three calorie, protein, and fat intake values into account
Estimated Poverty Rate (Headcount Ratio):	**54.9% (All India)**	❑ 37.2% (All India) ❑ Significantly higher than the 21.8% poverty figure from the 61st round of NSSO.	29.5%

The following table compares the methods used to estimate poverty rates in India by the Tendulkar Committee and the Rangarajan Committee.

Feature	Tendulkar Committee	Rangarajan Committee
Year report submitted	2009	2014
Metric used	Per capita monthly expenditure	Monthly expenditure of a family of five
Method used	MRP method	MMRP method
Factors considered in evaluating expenditure	Calorific value only	Calorie Protein Fat value
Poverty rate estimate for 2004-05 data	37.2%	29.5%
Method used to derive urban and rural poverty lines	All India urban poverty line basket	Separate rural and urban poverty line baskets

The Planning Commission later estimated poverty ratios for the years 2009-10 and 2011-12 using the Tendulkar and Rangarajan methods separately. The results were as follows:

Methodology	Poverty in 2009-10	Poverty in 2011-12	Extent of Reduction in Poverty
Tendulkar	29.8%	21.9%	7.9%
Rangarajan	38.2%	29.5%	8.7%

The poverty ratio derived through the Rangarajan method is higher than that derived through the Tendulkar method for both financial years.

According to the **Tendulkar report,** individuals spending less than **Rs. 27 per day in rural areas** and **Rs. 33 per day in urban areas** were categorized as **Below Poverty Line (BPL),** resulting in a cut-off of 21.9% of the population in 2011-12.

However, this threshold faced widespread criticism from the media and society due to its perceived inadequacy. In response, the government formed another committee under **C. Rangarajan** to reassess the poverty estimation methodology. The Rangarajan committee increased the thresholds to **Rs. 32 per day in rural areas** and **Rs. 47 per day in urban areas,** leading to a revised poverty line estimate of 29.5% in 2011-12.

Currently in India, the **identification of impoverished individuals is carried out by State Governments**, drawing on information from **Below Poverty Line (BPL) censuses,** with the latest being the **Socio-Economic Caste Census 2011 (SECC 2011).**

Conducted by the States/Union Territories (UTs) simultaneously for both rural and urban areas, SECC 2011 was supported by the Government of India both technically and financially. The census gathered comprehensive data on households, covering individual particulars, housing, deprivation, employment, income, assets/amenities, and land ownership. It documented the socio-economic status of 17.97 crore rural households and 6.51 crore urban households.

SECC 2011 classified households into three groups:

- **Automatically Excluded:** Households meeting exclusion criteria, such as any of the 13 assets and income-based parameters, are automatically excluded from welfare benefits.
- **Automatically Included:** Households meeting inclusion criteria, satisfying any one of the 5 acute social destitution parameters, are automatically included for welfare benefits.
- **Others:** "Others" are ranked based on 7 indicators of deprivation and, budget permitting, may be eligible for welfare benefits.

Unlike BPL Censuses, **SECC-2011 introduces the ability to track household deprivation**, effectively addressing gaps with a focus on the multi-dimensionality of poverty. Outside the Census Act, it provides a unique opportunity to understand the specific deprivation of each household. The **Sumit Bose Committee (2017) recommended leveraging SECC 2011 data to identify beneficiaries for various government schemes.**

The government has utilized **SECC data** in implementing social welfare programs, including

- Pradhan Mantri Aawas Yojana Gramin,
- Deendayal Antyodaya Yojana-National Rural Livelihood Mission,
- Pradhan Mantri Jan Arogya Yojana-Ayushman Bharat,
- Pradhan Mantri Sahaj Bijli Har Ghar Yojana,
- Pradhan Mantri Ujjwala Yojana.

Several state governments also use it to implement the National Food Security Act, 2013.

The incorporation of SECC data in government programs facilitates evidence-based developmental interventions. Generating a program-specific priority list, considering the fiscal space of the welfare program, ensures targeted pro-poor interventions. The selection of beneficiaries is validated through Gram Sabhas, and identity is established through Aadhaar where legally allowed, minimizing duplication and fraud. This approach significantly enhances the government's effectiveness in addressing multidimensional poverty, transcending income or expenditure-based considerations.

POVERTY REDUCTION INITIATIVES

Since independence, the Government's approach towards poverty reduction is in three dimensions.

- Growth oriented (Since First Five-Year Plan)
- Poverty alleviation Programs (Since Third Five Year Plan)
- Providing basic minimum amenities (Since Fifth Five Year Plan]

Government Initiatives Take Center Stage

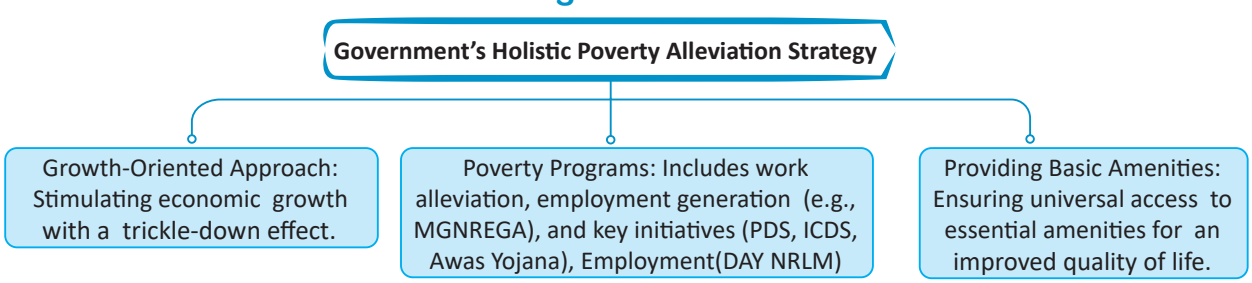

Government's Holistic Poverty Alleviation Strategy
Growth-Oriented Approach: Stimulating economic growth with a trickle-down effect.
Poverty Programs: Includes work alleviation, employment generation (e.g., MGNREGA), and key initiatives (PDS, ICDS, Awas Yojana), Employment(DAY NRLM)
Providing Basic Amenities: Ensuring universal access to essential amenities for an improved quality of life.

Fig. 3.5: Government's Holistic Poverty Alleviation Strategy

Dramatic Decline in Multidimensional Poverty

- A record 135 million people escaped multidimensional poverty between 2015-16 and 2019-21, marking a 9.89% decrease in overall poverty rate (24.85% to 14.96%).
- Rural areas witnessed the fastest progress, with poverty dropping from 32.59% to 19.28%, while urban areas saw a decline from 8.65% to 5.27%.

Holistic Approach: Measuring Deprivation Across Key Indicators

- The National Multidimensional Poverty Index (MPI) focuses on health, education, and standard of living, encompassing 12 indicators like nutrition, sanitation, education, and housing.
- Marked improvement is seen across all 12 indicators, demonstrating a comprehensive approach to tackling poverty.
- **Health:** Poshan Abhiyan and Anaemia Mukt Bharat address malnutrition and anemia, leading to health improvements.
- **Sanitation and Hygiene:** Swachh Bharat Mission and Jal Jeevan Mission have significantly improved access to sanitation and clean drinking water.
- **Financial Inclusion:** Pradhan Mantri Jan Dhan Yojana empowers individuals with bank accounts, boosting financial access.
- **Other Key Programs:** Saubhagya (LPG connections), PMAY (housing), and Samagra Shiksha (education) all contribute to poverty reduction.

Low Deprivation Rates Reflect Progress

- Remarkably low deprivation rates in areas like electricity access, bank accounts, and drinking water showcase the government's dedication to improving lives.

Moving Forward: Building on the Momentum

- This significant progress highlights the effectiveness of India's multi-pronged approach to fighting poverty.
- Sustained efforts must continue to further reduce deprivation and ensure inclusive development for all.

IGNITE YOUR MIND

Today, the world is witnessing what is called 'fourth Industrial Revolution', a term to describe rapid technological transformation in the world. What are some key socio-economic challenges you think IR 4.0 poses?

AMARTYA SEN'S CAPABILITY APPROACH ON POVERTY

The capability approach is centered on people, aiming to enhance well-being by expanding their capabilities for a life they value. Rather than endorsing welfare programs, it advocates empowerment initiatives.

This approach is grounded in two key principles:

- **Primary Moral Importance of Freedom:** Emphasizes the freedom to achieve well-being as a fundamental moral value.
- **Understanding Well-being:** Defines well-being in terms of people's capabilities and functionings.

Consequently, development is viewed as a process that creates an enabling environment for individuals to achieve valuable function and have the freedom to pursue their valued pursuits.

However, critics have noted the capability approach's perceived individualism, under-theorization, and information gaps.

Sen Index of Poverty

Developed by Nobel Laureate Prof. Amartya Sen in 1976, this index gauges poverty's extent, severity, and inequality in a country. It incorporates three elements: Head Count Ratio (H), Poverty Gap Index (I), and Gini Coefficient (G).

Mathematically:

$$S = H \times (I + (I + (1 - I) \times G)$$

Where:

- S: Sen Index of Poverty
- H: Head Count Ratio
- I: Poverty Gap Index
- G: Gini Coefficient

RANDOMIZED CONTROLLED TRIAL (RCT) IN POVERTY ALLEVIATION RESEARCH

The 2019 Nobel Laureates in Economics—Abhijit Banerjee, Esther Duflo, and Michael Kremer—played a crucial role in advancing the use of Randomized Controlled Trials (RCT) to assess the **effectiveness of diverse policy interventions** aimed at poverty alleviation.

An RCT is an experimental design crafted to isolate the impact of a specific intervention or variable on an outcome or event. For instance, a researcher aiming to understand the influence of increased teacher employment on children's learning outcomes can employ an RCT to obtain meaningful insights.

Bare Necessities Index

The concept of the Bare Necessities Index, introduced in the Economic Survey 2020-21, underscores the critical importance of universal access to fundamental requirements such as housing, water, sanitation, electricity, and clean cooking fuel. These essentials are consumed by all members of a household.

The index is calculated using 26 indicators based on five dimensions: water, sanitation, housing, micro-environment, and other facilities.

UNIVERSAL BASIC INCOME: A SINGLE SOLUTION FOR WELFARE

The **Economic Survey of 2016-17** ignited a conversation about Universal Basic Income (UBI), a radical concept where everyone receives an unconditional cash payment, regardless of their economic status. This revolutionary idea has sparked both hope and debate across the globe.

Empowering Citizens with Basic Income

At its core, UBI rests on three pillars: universal access, no strings attached, and individual agency. This empowers citizens by guaranteeing a basic income for their essential needs, freeing them to pursue their aspirations and choices. Proponents argue that UBI could:

- **Unleash Individual Freedom:** Individuals would have the flexibility to spend their income as they see fit, fostering entrepreneurship and innovation.
- **Address Technological Unemployment:** In developed nations, automation threatens jobs; UBI could provide a safety net and facilitate adaptation.
- **Reduce Inequality:** By ensuring a minimum income, UBI could address wealth disparities and stimulate aggregate consumer demand.
- **Promote Social Justice:** The agency it provides empowers individuals, especially the poor, to make informed economic decisions.

Replacing a Labyrinth of Welfare Schemes

UBI's proponents envision it as a replacement for the existing plethora of welfare schemes (around 950), which costs the government approximately **5.2% of GDP.** Streamlining through UBI could offer several benefits:

- **Enhanced Efficiency:** Replacing numerous schemes with one simplifies administration, minimizing bureaucratic hurdles and leakages.
- **Improved Transparency:** Monitoring a single program becomes significantly easier, increasing accountability and transparency.
- **Eradicating Corruption:** By removing complex procedures, UBI could help mitigate opportunities for corruption and misuse of funds.

Addressing the Challenges of Implementation

While UBI holds immense promise, its implementation presents several challenges:

- **Technological Infrastructure:** A robust JAM infrastructure (Jan Dhan, Aadhar, Mobile) is crucial for effective rollout.
- **Financial Burden:** The cost of UBI, **estimated at 4.9% of GDP**, requires careful consideration and resource allocation.
- **Implementation Challenges:** The banking system, particularly in rural areas, needs strengthening to ensure smooth distribution.
- **Potential Misuse:** Concerns exist about individuals misusing their UBI on non-essential items.

A Global Experiment with Uncertain Future

Several countries, including Canada, Brazil, and Iran, have experimented with UBI on a pilot basis. However, no major economy has implemented it nationwide. This lack of precedent necessitates:

- **In-depth Analysis:** A thorough study of UBI's economic and social implications is crucial before large-scale implementation.
- **Open Dialogue:** Public engagement and debate are essential to ensure UBI aligns with societal values and aspirations.

UBI offers a potential transformative solution to poverty, inequality, and the challenges of the modern economy. However, careful consideration and planning are necessary before embarking on this revolutionary path. By conducting thorough research, fostering open dialogue, and ensuring robust infrastructure, UBI could pave the way towards a more just and equitable future for all.

UNDERSTANDING INCOME INEQUALITY: CAUSES AND MEASUREMENT

Income inequality is the difference in earnings between the affluent and less affluent members of society, illustrating the uneven distribution of economic resources. As per Oxfam international the top 10% of the Indian population holds 77% of the total national wealth.

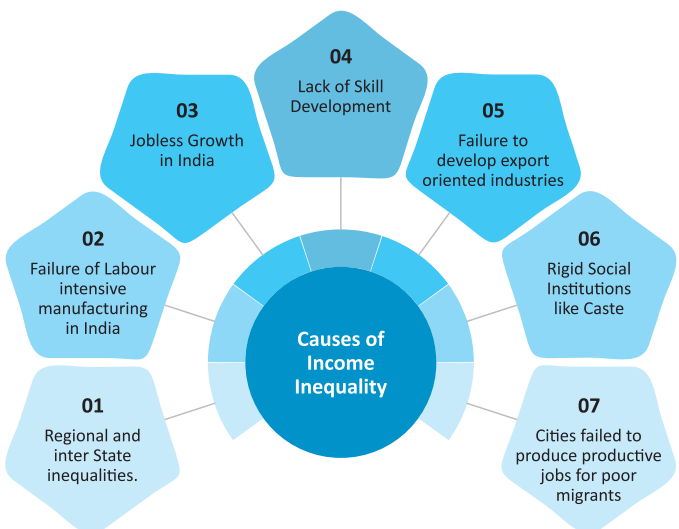


Fig. 3.6: Causes of Income Inequality

Methods to Assess Income Inequality

Relative Poverty Concept: Evaluates a nation's income inequality, measured through mathematical **Gini Coefficient** and **graphical Lorenz curve**.

- **Gini Coefficient or Gini Index:**
  - Developed by Italian statistician Corrado Gini in 1912.
  - It gauges income inequality by calculating the ratio of the area between the diagonal line (perfect equality) and the Lorenz curve to the total area of the corresponding half square.
  - The Gini Coefficient **ranges from 0 to 1.**

- 0 signifies perfect equality, where all residents have the same income.
- 1 indicates perfect inequality, with one resident earning all income and others having none.
- A **higher Gini Coefficient indicates increased income inequality**, emphasizing the gap between the rich and poor in a country. For instance, a rise from 0.29 to 0.36 implies worsening income inequality, negatively impacting the economy.

❑ **Lorenz Curve:**

- It's a curve that gauges the connection between the proportion of income earned and the proportion of individuals who earned that specific share of income.
- It is a **graphical representation of the Gini Coefficient**. In other words, the Gini Coefficient can be represented graphically through the Lorenz curve.
- Cumulative population share (in %) is presented on the X-axis and cumulative income share (in %) is presented on the Y-axis.

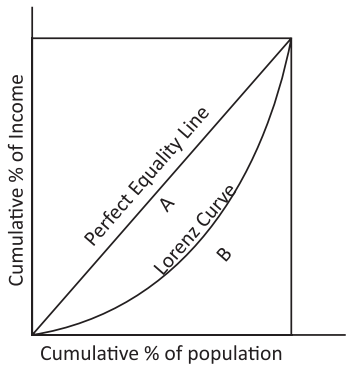


Fig. 3.7: Lorenz Curve

❑ **Lorenz curve explained:**

- Perfect equality is represented by a straight 45-degree curve.
- Curve placed below the line of perfect equality represents the Lorenz curve.
- The closer is the Lorenz curve to the perfect equality line, the less is the level of income inequality and vice versa.
- 'A' indicates the shaded area.
- From the graph, Gini Coefficient shaded area A/area of AB.
- If A = 0 it means the Lorenz curve is actually the line of equality, and then it indicates perfect equality with Gini Coefficient = 0.

PRESENT STATUS OF INCOME INEQUALITY IN INDIA

The **State of Inequality in India Report** was released 18 May **2022** by Dr Bibek Debroy, Chairman, Economic Advisory Council to the Prime Minister (EAC-PM)**.** The report has been written by the Institute for Competitiveness and presents a holistic analysis of the depth and nature of inequality in India.

Consisting of two parts – **Economic Facets and Socio-Economic Manifestations** – the report looks at **following key areas** that influence the nature and experience of inequality. These are

❑ **Income distribution:** With a first-time focus on income distribution to understand the capital flow, the report emphasises that wealth concentration as a measure of inequality does not reveal the changes in the purchasing capacity of households. Extrapolation of the income data from Periodic labour force survey 2019-20 has shown that a monthly salary of Rs 25,000 is already amongst the top 10% of total incomes earned, pointing towards some levels of income disparity.

❑ **Labour market dynamics:** In 2019-20, among different employment categories, the highest percentage was self-employed workers (45.78%), followed by regular salaried workers (33.5%) and casual workers (20.71%). The share of self-employed workers also happens to be the highest in the lowest income categories. The country's unemployment rate is 4.8% (2019-20), and the worker population ratio is 46.8%

❑ **Health:**

- The results of NFHS-4 (2015-16) and NFHS-5 (2019-21) have shown that 58.6% of women received antenatal check-ups in the first trimester in 2015-16, which increased to 70% by 2019-21. 78% of women received postnatal care from a doctor or auxiliary nurse within two days of delivery, and 79.1% of children received postnatal care within two days of delivery.
- However, nutritional deprivation in terms of overweight, underweight, and prevalence of anaemia (especially in children, adolescent girls and pregnant women) remains areas of huge concern requiring urgent attention, as the report states.

❑ **Education and Household characteristics:**

- According to the report, education and household conditions have improved enormously due to targeted efforts through several social protection schemes, especially in the area of water availability and sanitation that have increased the standard of living
- The Gross Enrolment Ratio has also increased between 2018-19 and 2019-20 at the primary, upper primary, secondary and higher secondary. In terms of improvement in household conditions, emphasis on providing access to sanitation and safe drinking water has meant leading a dignified life for most households. According to NFHS-5 (2019-21), 97% of households have electricity access, 70% have improved access to sanitation, and 96% have access to safe drinking water.

The report stretches the narrative on inequality by presenting a comprehensive analysis that shapes the ecosystem of various deprivation in the country, which directly impacts the well-being of the population and overall growth. It is a study that cuts across the intersections of class, gender, and region and highlights how inequality affects the society.

THE STARK LANDSCAPE OF INEQUALITY: INDIA AND THE GLOBAL DIVIDE

A shadow of inequality hangs over India, revealed in stark detail by the **World Inequality Report 2022**. This report, penned by the esteemed **Paris-based World Inequality Lab**, unveils a sobering reality: a nation where the **top 1% holds a staggering fifth of the total national income, while millions struggle to make ends meet.**

The report paints a vivid picture of **income disparities:**

- The average Indian adult earns a modest Rs 2,04,200 annually. Yet, this figure pales in comparison to the wealth amassed by the top 10%, who earn over 20 times more, a staggering Rs 11,66,520. This chasm leaves the bottom 50% struggling on a mere Rs 53,610.
- The world inequality report pointed that the top 10% of the population holds 57% of the total income while the bottom 50% share has gone down to 13%

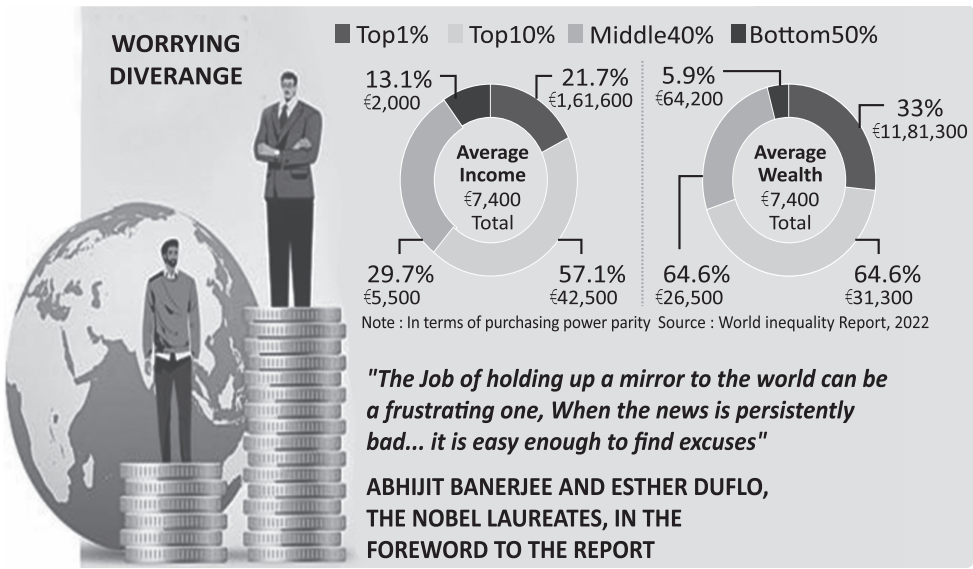


Fig. 3.8: Income and Wealth Inequality

- Gender inequalities further compound the economic divide. Women, despite comprising half the population, face limited access to opportunities. Their share of the total income from work has been steadily declining, currently standing at a mere 18% – a figure that lags even behind the Middle East's 15%.

The report also sheds light on the **challenges faced by India's middle class:**

- Despite being the backbone of the economy, the average middle-class household possesses wealth of only Rs 7,23,930, a meager 29.5% of the total national income. This pales in comparison to the riches of the top 10% and 1%, who hold a disproportionate share of the nation's wealth.

However, the report also offers a glimmer of hope:

- The pre-tax national income share of the top 10% and bottom 50% has remained relatively constant since 2014. This suggests that while inequality remains a significant challenge, it is not insurmountable.

Looking beyond India, the report reveals a **global landscape marked by vast disparities**:

- The poorest half of the world's population owns a mere 2% of the total wealth, highlighting the immense concentration of resources in the hands of a select few.
- In stark contrast, the richest 10% globally hold a staggering 76% of all wealth, highlighting the stark divide that separates the privileged few from the vast majority.

The **World Inequality Report 2022 serves as a wake-up call**, urging immediate action to address the growing economic divide. By investing in education and skill development, promoting fair wages, and strengthening social safety nets, India and the world can move towards a more equitable and just future which will minimise conflicts.

GOVERNMENT INITIATIVES TO ADDRESS INCOME INEQUALITY

- **Land Reforms:** Implementation of measures to address disparities in land ownership.
- **Monopoly and Trade Practices Control:** Historical initiatives like the MRTP Act (now abolished) and the current Competition Act, 2002, aimed at curbing monopolies and restrictive trade practices.
- **Employment Generation:** Implementation of schemes such as MGNREGA, DDU- NRLM, DDU-NULM to generate employment opportunities.
- **Progressive Taxation:** Adoption of a progressive taxation system under direct taxes.
- **Education and Job Access:** Efforts to provide more equal access to education and well-paying jobs such as Special Economic Zones in National Education Policy.

Eradicating Poverty and Empowering Communities

- **Strengthening Social Safety Nets:**
  - Pradhan Mantri Suraksha Bima Yojana (Accident Insurance)
  - Atal Pension Yojana (Unorganized Sector)
  - Pradhan Mantri Jeevan Jyoti Yojana (Life Insurance)
- **Boosting Entrepreneurship:**
  - MUDRA Bank for microfinance loans
  - National Hub for SC/ST entrepreneurs
- **Financial Inclusion:**
  - Prime Mantri Jan Dhan Yojana for bank accounts

Additional Measures

Despite these efforts, critics argue that the impact on reducing income inequality has been limited. Additional suggested measures include:

- **Taxing the Super-Rich:** Re-introducing measures like inheritance tax and wealth tax to ensure the affluent contribute more.
- **Promoting Inclusive Growth:** Encouraging labour-intensive sectors and emphasising agriculture and social protection schemes for inclusive growth.
- **Enhancing Data Transparency and Financial Inclusion:** Maintaining transparency in data and improving financial inclusion for a more comprehensive approach to addressing income inequality.

UNEMPLOYMENT IN INDIA - URBAN AND RURAL

A person in employment, as defined by the **International Labour Office (ILO)** is a person aged 15 or over who has done at least one hour's paid work in a given week or who is absent from work for certain reasons (annual leave, sickness, maternity, etc.) and for a certain period of time.

All forms of employment are covered (employees, self-employed, family helpers), whether the employment is declared or not.

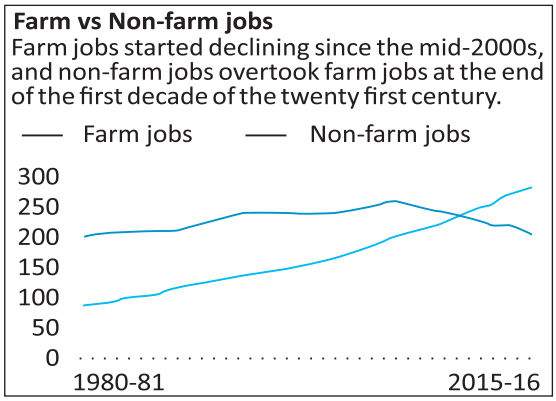


Fig. 3.9: Farm vs Non-fram Jobs

The definition of unemployment highlights the following aspects:

- **Non-Permanent Nature:** Unemployment is not permanent; it denotes temporary joblessness.
- **Applicability to Working-Age Individuals:** It pertains specifically to able-bodied individuals within the working age, typically between 15 and 60 years, who are mentally and physically capable of working.
- **Ability and Willingness to Work:** The definition emphasizes that the individual not only possesses the ability to work but also expresses a willingness to engage in work.
- **Age Criterion:** Unemployment applies to those within the age range of 15 to 60 years who, despite having the capability and willingness, fail to secure work at the prevailing wage rate.

The construction sector has accounted for more than a third of new jobs in post-liberalization India

Share of new non-farm jobs created between				
Sectors	1980-81 and 1990-91 (in %)	1990-1991 and 2015-16 (in %)	Share in total work force in 2015-16 (in %)	Productivity per worker (Rs.1,000/ worker in 2015-16)
Construction	20.13	**35.74**	14.40	126.56
Trade	24.84	**14.56**	10.04	235.78
Miscellaneous services	7.38	**8.43**	5.02	415.53
Transport and storage	9.78	**7.44**	4.29	255.39
Education	3.13	**6.26**	3.22	222.13
Business services	1.47	**5.99**	2.18	811.68
Hotel and restaurants	2.49	**3.75**	1.89	123.53
Gems, jewellery and misc. manufacturing	3.02	**2.46**	1.43	87.49
Food products, beverages and tobacco	4.92	**2.28**	2.42	158.72
Financial services	2.42	**2.26**	1.11	1259.52
Health and social work	0.81	**2.07**	1.08	290.04

Note: Only sectors which account for at least 1% of the total workforce have been considered here.

Fig. 3.10: Job-Generators

- **Underemployment:** When individuals work in positions that do not fully utilize their education or skill level, it is referred to as 'underemployment.' This phenomenon can manifest in two forms: visible and invisible underemployment.

Causes of Unemployment in India

Several factors contribute to unemployment in India:

- **Slow Economic Development:** The pace of economic development, when sluggish, can result in job scarcity.
- **Population Explosion:** Rapid population growth exacerbates the demand for jobs, outpacing available opportunities.
- **Education System Gaps:** An inadequate education system may lead to a mismatch between required skills and the skills available in the workforce.
- **Skills Gap:** Mismatch between the skills demanded by the job market and the skills possessed by the workforce contributes to unemployment.
- **Limited Impact of Government Planning:** The effectiveness of government planning in mitigating unemployment is constrained, leading to persisting joblessness.
- **Lower growth** in labor intensive sectors such as apparel,leather.

VARIOUS UNEMPLOYMENT CONCEPTS

- **Labour Supply**
  - This concept pertains to the supply of labour (in man-days) that workers are ready to offer at varying wage rates.

- The relationship between labour supply and wage rate is intrinsic.
- The supply of labour can fluctuate irrespective of the constant number of workers.

❑ **Labour Force**
- The term denotes the number of individuals actively engaged in work or willing to work.
- Unlike labor supply, it is not contingent on the wage rate.
- Measurement is in terms of the number of persons, not man-days or person-days.

❑ **Workforce**
- This concept encompasses only those individuals currently engaged in work.
- It does not consider those willing to work but currently unemployed.
- A beggar, thief or gambler is not considered a worker.

Unemployment Metrics

❑ **Number of Unemployed Individuals:** Calculated as the difference between the labor force and the workforce.

❑ **Unemployment Rate:** Determined by dividing the number of unemployed persons by the total labor force and multiplying by 100.

❑ **Proportion of Unemployed:** Expressed as the number of unemployed persons divided by the total population, multiplied by 100.

❑ **Labour Force Participation Rate (LFPR):** Computed by dividing the labor force by the total population and multiplying by 100.

❑ **Work Force Participation Rate (WFPR):** Calculated by dividing the workforce by the total population and multiplying by 100.

❑ **Employment Intensity:** Represents the number of employed individuals per lakh of Real GDP.

METHODS TO MEASURE UNEMPLOYMENT IN INDIA

In line with the recommendations from Prof. **M.L. Dantwala Committee** established by the **Planning Commission in 1960,** the National Sample Survey Organization [Now known as National Statistical Office (NSO)] has employed three methods since 1972-73 to gauge unemployment through National Sample Survey data:

❑ **Usual Status(US):**
- This method assesses the number of individuals persistently unemployed for a significant part of the preceding year before the survey date.
- Typically yields the lowest unemployment estimate, reflecting that only a limited number of people can sustain prolonged periods without employment.

❑ It is further divided into Principle Activity Status and Subsidiary Activity Status
- **Principal activity status(PS):** The activity status on which a person spent relatively long time (major time criterion) during 365 days preceding the date of survey, was considered the usual principal activity status of the person.
- **Subsidiary economic activity status(SS):** The activity status in which a person in addition to his/her usual principal status, performs some economic activity for 30 days or more for the reference period of 365 days preceding the date of survey, was considered the subsidiary economic status of the person.
- PS+ SS= Usual Principal and Subsidary Status

❑ **Current Weekly Status (CWS):**
- With a reference period of one week (7 days before the survey), this method deems a person 'employed' even if they worked for just one hour during that week.
- The CWS adopts a shorter reference period of a week. An individual is counted as being employed if they have worked for at least one hour on at least one day during the seven days preceding the date of survey. UPSS unemployment rates will always be lower than CWS rates because there is a greater probability that an individual would find work over a year as compared to a week.

❑ **Current Daily Status (CDS):**
- The reference period here is the day immediately preceding the survey date.
- Designates a person as 'employed' if they worked for a minimum of 4 hours on that day.
- If an individual worked for more than 1 hour but less than 4 hours, they are considered half-day employed.
- Those with no gainful work for at least 1 hour on that day are categorized as unemployed.
- CDS typically yields the highest unemployment estimate among the three methods.

Best method is CDS as it is broadest measure and is more inclusive, captures open employment to a great extent, takes care of seasonality, and CDS indicates the magnitude of both unemployment and underemployment.

ESTIMATES OF UNEMPLOYMENT IN INDIA UNDER THE THREE METHODS (AS A PERCENTAGE OF LABOUR FORCE)

Estimates of Unemployment The NSO adopts two major measures for classifying the working status of individuals in India. These are the Usual Principal and Subsidiary Status (UPSS) and the Current Weekly Status (CWS).

Method Used	1972-73	2009-10	2015-16
UPS	1.6%	2.5%	5.0%
CWS	4.3%	3.6%	-
CDS	8.3%	6.6%	-

Note: The estimate is the highest under CDS

According to **periodic labour force survey annual report 2022-23.** In rural areas, Unemployment Rate decreased from 5.3% in 2017-18 to 2.4% in 2022-23 while for urban areas it decreased from 7.7% to 5.4%. Unemployment Rate for male in India decreased from 6.1% in 2017-18 to 3.3% in 2022-23 and corresponding decrease in Unemplyment Rate for female was from 5.6% to 2.9%.

TYPES OF UNEMPLOYMENT

It can be Broadly Divided Into Two Categories

- **Voluntary Unemployment:**
  - This happens when people choose not to work even though jobs are available.
  - They may be taking a break, caring for family, pursuing education, or simply not interested in the available jobs.
  - In this case, they are not considered "officially" unemployed.
- **Involuntary Unemployment:** This occurs when people are willing to work but cannot find jobs due to reasons beyond their control.

This includes various **sub-categories**:

- **Structural Unemployment:**
  - This happens due to changes in the economy, such as new technologies or industries replacing old ones.
  - Workers whose skills are no longer in demand become unemployed.
- **Disguised Unemployment:**
  - This exists when people are technically employed but not actually contributing to production.
  - This is common in agriculture, where underemployment disguised as employment exists.
- **Frictional Unemployment:** This is temporary unemployment due to short-term factors like changing jobs, strikes, or seasonal fluctuations in work.
- **Cyclical Unemployment:** This occurs during economic downturns when businesses decrease production and lay off workers.
- **Chronic Unemployment:** This is long-term unemployment, often caused by poverty, lack of skills, or limited economic opportunities.
- **Technological Unemployment:** This arises when machines and technology replace human labor, leading to job losses.
- **Casual Unemployment:** This is temporary unemployment in sectors like construction or agriculture, where work is available only for specific periods.
- **Seasonal Unemployment:** This occurs in sectors like tourism or agriculture, where work is only available during certain seasons.
- **Disguised unemployment** isn't just a farm problem. It's also found in public sector jobs where people are paid to do little or nothing. This hidden unemployment hurts the economy and needs to be fixed. We need to reform both agriculture and other sectors to make them more efficient and use workers effectively. This will create a more productive and dynamic economy.

CASUALISATION AND INFORMALISATION OF WORKFORCE

Unemployment can have a significant impact on individuals and society as a whole. Understanding the different types of unemployment is crucial for developing effective policies to address this issue. To comprehend this, let's begin by defining the following:

Distinction between Casual Workers and Regular Workers

Workers fall into two categories—self-employed or hired. Among hired workers, there are casual workers and regular workers.

- **Casual Workers:** Engaged on a daily wage basis, they do not receive social security benefits such as provident fund, gratuity, or pension.
- **Regular Workers:** On a permanent payroll, they are entitled to all social security benefits.

Distinguishing Formal Workers From Informal Workers

As per the National Commission for Enterprises in the Unorganised Sector (NCEUS), workers in the organized sector (encompassing government departments, public enterprises, and private establishments hiring 10 or more workers) are termed formal workers. On the other hand, those in the unorganized sector (i.e., enterprises hiring less than 10 workers) are referred to as informal workers.

Increasing Casualisation in India

The rise of casualisation in India is a concerning trend, impacting millions of workers and raising questions about job security and economic stability. Here are some data points and reports highlighting this issue:

- **Centre for Monitoring Indian Economy (CMIE):**
  - **CMIE's Employment-Unemployment Survey 2022-23 (June-July)** reveals that casual workers constitute a significant 29.3% of the total workforce in India.

This represents an increase from 27.5% in 2021-22 and 26.2% in 2020-21.

- The survey further shows that the growth in casual employment is primarily driven by an increase in the rural sector, where casual workers now make up 37.1% of the workforce.

- **International Labour Organization (ILO):**
  - ILO's World Employment and Social Outlook - Trends 2023 report estimates that India's informal employment rate (which includes casual work) is expected to remain high, at around 84% in 2023.
  - The report also highlights the vulnerability of informal workers, who often lack social protection and face precarious working conditions.
- **Periodic Labour Force Surveys (PLFS):**
  - PLFS data from 2019-20 (latest available) shows that casual workers represent 56.9% of the non-agricultural workforce in India.
  - This figure has been steadily increasing over the years, indicating a growing trend of casualisation across industries.
- **Reports by Think Tanks and Research Institutions:**
  - Azim Premji University's 2022 report "India's Employment Crisis: Evidence from Household Surveys" emphasizes the increasing precariousness of work in India, with casualisation being a major factor.
  - The Centre for Sustainable Employment's 2021 report "The Gig Economy in India: A Preliminary Assessment" highlights the rise of gig work, which often falls under the umbrella of casual employment and raises concerns about worker exploitation and social security.

The **rise in casualization** can be attributed to the following factors:

- **Rural-Urban Migration:** Disguised employed rural workers migrate to urban areas in pursuit of non-farm employment. Due to a lack of proper skills and training, they often find work as casual workers in urban settings.
- **Real Estate Boom and MGNREGS:** The rapid growth in the real estate sector in urban areas and the implementation of the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) in rural areas have led to increased employment in the construction sector. This, in turn, has resulted in a higher prevalence of casual or daily-rated workers.
- **Informalization Impact:** The trend of informalization has further contributed to the casualization of the workforce.

The solution to this issue lies in educational reforms and increased government initiatives for skill development. To reduce casualization, the government should also encourage self-employment by facilitating easy access to credit and providing supportive infrastructure.

INCREASING INFORMALISATION IN INDIA

CMIE's Employment-Unemployment Survey 2022-23 (June-July) reveals a staggering 84.9% of the workforce in India falls under the informal sector. This figure has remained stubbornly high for years, highlighting the persistent nature of the issue.

The swift increase in informalization can be attributed to several factors:

- The shift from a 'controlled economy' to a 'market economy' following the LPG reforms since 1991-92. There exists a significant correlation between the market economy and the informalization of the workforce.
- Insufficient vocational skills among the entry-level labour force contribute to this trend.
- Complex labor laws and regulations pose challenges for the growth of private firms in the formal sector. As a convenient alternative, these firms often rely on casual or contractual workers.
- The insufficient emphasis on the Micro, Small, and Medium Enterprises (MS&ME) sector, which holds substantial potential as a formal sector.

The growing trend of informalization renders the workforce more susceptible to the uncertainties of a market economy. It is imperative to formulate and implement a well-considered strategy to address and diminish this trend.

IGNITE YOUR MIND

The Constitution of India mentions the Indian state as a welfare state. Poverty, Inequality and Unemployment are key challenges that go against the idea of a Welfare state. Mention articles or provisions mentioned in the constitution which directly or indirectly aims to eradicate these challenges?

PERIODIC LABOUR FORCE SURVEY (PLFS) AND ALL-INDIA QUARTERLY ESTABLISHMENT-BASED EMPLOYMENT SURVEY (AQEES)

The NSSO's Employment and Unemployment Surveys (EUS) traditionally served as the primary source for national and state-level labour market data in India, conducted **every five years** since 1972. Recognizing the need for more frequent labour force data, the National Statistics Office (NSO) under the Ministry of Statistics and Programme Implementation initiated PLFS to provide annual employment and unemployment statistics for both rural and urban areas, with

quarterly estimates specifically for urban areas. The initial annual report, based on PLFS data collected from July 2017 to June 2018, was published in May 2019.

PLFS had Two Primary Objectives

- To gauge the **dynamics in labour force participation and employment status** within a short three-month interval, exclusively for urban areas.
- To measure key labour force parameters on an annual basis for both rural and urban areas, including the labour force participation rate and worker population ratio.

All-India Quarterly Establishment-based Employment Survey (AQEES)

Launched by the **Labour Bureau under the Ministry of Labour and Employment**, AQEES provides quarterly updates on employment and related variables across organized and unorganized segments in nine selected sectors, representing a significant portion of total non-farm employment. These sectors encompass Manufacturing, Construction, Trade, Transport, Education, Health, Accommodation and Restaurant, IT/BPO, and Financial Services.

AQEES Comprises Two Components

- **Quarterly Employment Survey (QES):** Covers establishments with 10 or more workers, predominantly constituting the organized segment.
- **Area Frame Establishment Survey (AFES):** Focuses on establishments with 9 or fewer workers, mainly in the 'unorganized' segment.

Key highlights from the first round of QES (April to June 2021) include:

- Nearly 90% of establishments operate with less than 100 workers.
- Female workers' overall participation stands at 29%.

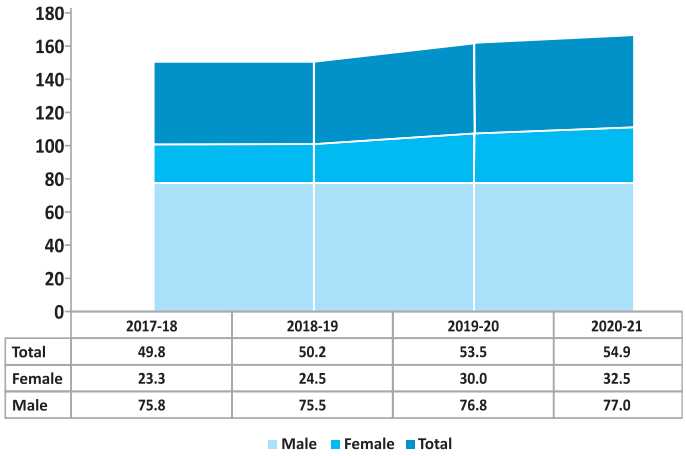
AFES fieldwork is currently underway.

AQEES (QES and AFES) aims to provide regular updates on the employment scenario from the demand side, catering to policy planning needs. While Economic Censuses offer establishment-based data, they are conducted irregularly and do not cover all establishment types. The 7th Economic Census [2020] results are yet to be made public.

SIZE OF WORKFORCE

Ministry of Labour and Employment important report "**Labour and Employment Statistics 2022**

- **Key Indicator 1: Labour Force Participation Rate Rise in Labour Force Participation Rate (LFPR):** LFPR for persons of age 15 years and above was 49.8%, 50.2% and 53.5% during 2017-18, 2018-19 and 2019- 20, respectively. During 2020-21, LFPR increased to 54.9%.
  - Female LFPR showed a significant increase of 9.2% points, from 23.3% in 2017-18 to 32.5% during 2020-21.
  - Male LFPR increased to 77.0% during 2020-21 from 75.8% in 2017-18, an increase of 1.2% points.



	2017-18	2018-19	2019-20	2020-21
Total	49.8	50.2	53.5	54.9
Female	23.3	24.5	30.0	32.5
Male	75.8	75.5	76.8	77.0

Fig. 3.11: Service : Periodic Labour Force Survey, MoSPI

- **Key Indicator 2: Status in Employment:** The share of workers in Self-Employment (Own-account workers and helpers in Household enterprises) increased to 55.6% in 2020-21 as compared to 52.2% in 2017-18.
  - During 2020-21, the larger proportion of female workers was engaged as Helper in household enterprises with 36.6% followed by 23.2% Casual Labour.
  - Around 44.8% male workers were engaged as Own account workers and Employers followed by 22.7% Regular wage/salaried during 2020-21.
- **Key Indicator 3: Employment by Sector:**
  - **Agriculture sector** is the biggest absorber of workers in India and provided employment to around 46.5% of total workers during 2020-21 as compared to 44.1% in 2017-18.
    - During 2018-19, **Services and Industry sectors** showed a rise to 32.3% and 25.2% from 31.1% and 24.8% in 2017-18, respectively. In 2019-20, percentage of workers in these sectors declined and services sector continued to decline in 2020-21 as well, as an obvious impact of world-wide lockdown due to covid-19 outbreak.

  The workers in industries showed growth, though marginal, to 23.9% in 2020-21 from 23.7% in 2019-20.Female workers in agriculture sector increased to 62.2% during 2020-21 from 57.0% in 2017-18, while on the other hand, the male workers in this sector declined to 39.8% during 2020-21 over 40.2% in 2017-18. Contribution of female in Services and Industries declined during 2020-21 as compared to 2017-18, while male workers has increased in recent years
- **Key Indicator 4: Unemployment Contracted Unemployment rate (UR):** Unemployment rate was 6.0%,

5.8% and 4.8% during 2017-18, 2018-19 and 2019-20 respectively. During 2020-21, UR improved and declined to 4.2%. Female UR showed significant improvement and decreased to 3.5% in 2020-21 over 5.6% in 2017-18. Male UR decreased to 4.5% during 2020-21 from 6.1% in 2017-18.

HAS MGNREGA PLAYED A VITAL ROLE IN CURBING UNEMPLOYMENT, AND SHOULD IT BE SUSTAINED?

MGNREGA aims to ensure 100 days of guaranteed wage employment for every rural household, with the Government of India adjusting the wage rate over time since the program's initiation in 2006.

The Government of India's stipulated wage rate for MGNREGA varies across states, ranging from ₹7171 to ₹2284, as per the latest notification in March 2019. In response to the COVID-19 pandemic, the MGNREGA wage rate was raised by ₹20 in March 2020, and an additional ₹40,000 crore was allocated in 2020 as part of the government's stimulus package to address sudden livelihood crises.

Achievements of MGNREGA

- Increased job opportunities in rural areas.
- Enhanced participation of marginalized groups, including SC/STs and women, fostering social inclusivity.
- Improved financial inclusion through wage payments via bank and post office accounts.
- Creation of durable rural assets such as ponds, check dams, roads, and plantations.

Critics Highlight Inefficiencies, Including

- Delayed wage payments in several instances.
- Decreasing allocation for the wage component in the MGNREGA annual action plans of many panchayats.
- Reluctance in disbursing unemployment allowances to households that requested employment but were not provided.

Despite implementation challenges, MGNREGA has revitalized Panchayati Raj institutions and instilled a sense of entitlement among the deprived, acknowledged by the **UNDP in its 2015 Human Development Report** as a landmark employment guarantee scheme.

Hence, the continuation of MGNREGA is recommended, with a simultaneous emphasis on addressing implementation inefficiencies.

RECENT GOVERNMENT INITIATIVES TO REDUCE UNEMPLOYMENT

Employment generation is always the priority of the Government. The Government has taken various steps from time to time for generating employment in the country by implementing various employment generation schemes. The estimated employment generated under key schemes/programmes are as follows

S. No.	Schemes/Programmes	Employment Generated
1	**Pradhan Mantri Rojgar Protsahan Yojana (PMRPY)** To incentivize employers for creation of new employment launched w.e.f. August 2016.	As on 31.03.2022 Employees benefitted: 1.22 crore Establishments benefitted: 1.53 lakh
2	**Atmanirbhar Bharat Rojgar Yojana (ABRY)** To incentivize creation of new employment opportunities during the COVID recovery phase by providing incentive to the employers of establishments, launched w.e.f. October 2020 and terminated on March, 2022	As on 18.06.2022 Employees benefitted: 59.49 lakh Establishments benefitted: 1.49 lakh
3	**Pradhan Mantri Kaushal Vikas Yojana (PMKVY)** It is a Skill Certification Scheme, to enable a large number of Indian youth to take up industryrelevant skill training, launched w.e.f. July 2015.	As on 07.03.2022 Candidates Trained: 1.35 crore Candidates Placed: 23.96 lakh
4	**Pradhan Mantri Garib Kalyan Rozgar Abhyan (PMGKRA)** To incentivize employers for creation of new employment along with social security benefits and restoration of loss of employment during Covid-19 pandemic, launched w.e.f. June 2020 and terminated on 22nd October, 2020.	Ended on 22nd October, 2020. Employment Generated: 50.78 crore persondays Expenditure incurred: Rs. 39,293 crore
5	**Pt. Deen Dayal Upadhyaya-Grameen Kaushlya Yojana- DDU-GKY** To reduce poverty by enabling the poor households to access gainful self-employment and skilled wage employment opportunities through placement-linked skill training program, launched	During last five years (2017-18 to 2021-22) Candidates Trained: 6.78 lakh Candidates Placed: 4.22 lakh
6	Rural Self Employment Training Institutes (RSETIs) Skill Development through Rural Self Employment Training Institutes (RSETIs) enabling a trainee to take bank credit and start his/her own micro-enterprise.	As on 31.03.2022 (since April 2008) Candidates Trained: 35 lakh Candidates Settled: 24.41 lakh Candidates Settled under Wage Employment: 2.36 lakh Candidates Settled under Self Employment: 22.05 lakh

S. No.	Schemes/Programmes	Employment Generated
7	**Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA)** It aims at enhancing the livelihood security of people in rural areas by guaranteeing 100 days of wage employment in a financial year to a rural household whose adult members volunteer to do unskilled manual work	During 2021-22 Employment Generated: 363.49 crore personday
8	**Prime Minister's Employment Generation Programme (PMEGP):** It focuses on generating employment in the country by setting up of new self-employment ventures/ projects/ micro-enterprises in the nonfarm sector.	During 2021-22 (upto 15.03.2022) Employment generated: 6.91 lakh persons
9	**Pradhan Mantri Mudra Yojna (PMMY)** To fund the unfunded micro enterprises segment through a new financial inclusion initiative, launched on April 8, 2015	During 2021-22 No. Of PMMY Loans Sanctioned: 5.38 crore Amount Disbursed : 3,31,402 crore
10	**PM Street Vendors Atma Nirbhar Nidhi (PM SVANidhi)** scheme to give vendors access to affordable working	As on 31.03.2022 Applications sanctioned: 33.73 lakh loan amount disbursed against 30.89 lakh applications
11	**Employment Provident Fund Organization (EPFO)** Provides Net payroll data	During 2021-22 Net subscribers: 122.35 lakh

THE RISE OF THE GIG ECONOMY IN INDIA: A STORY OF OPPORTUNITY AND CHALLENGES

In the bustling streets of India, a new wave of work is taking shape. It's not the traditional 9-to-5 grind, but a dynamic world of temporary gigs and short-term contracts – the gig economy. This fast-paced ecosystem is changing the landscape of work, offering flexibility and freedom while also raising questions about security and fair treatment.

What is the Gig Economy?

Imagine a marketplace where companies can hire workers for specific tasks, from delivering food to writing articles, all on a short-term basis. That's the essence of the gig economy. Startups like Ola, Uber, and Zomato have become synonymous with this model, providing opportunities for millions of Indians to earn a living outside the traditional office setting.

Who are the Gig Workers?

They're a diverse bunch – students seeking extra income, skilled professionals looking for flexibility, and even those juggling multiple gigs to make ends meet. The **Code on Social Security** defines them as "individuals who earn from work arrangements outside the traditional employer-employee relationship." This includes online platform workers, independent contractors, and temporary workers.

How Big is it?

The gig economy is booming in India. Studies estimate that about 47% of gig work falls in the medium-skilled category, with high-skilled and low-skilled jobs occupying the remaining slots. Research suggests that developing countries like India have a higher participation rate in the gig economy compared to their developed counterparts. By 2029, the gig workforce in India is expected to touch a staggering 2.35 crore!

The Average Gig Worker

The typical Indian gig worker is young, with a median age of 27. Their average monthly income is around Rs 18,000, and for many, it's the sole source of income for their families. They operate within a household size of around 4.4 members, highlighting the crucial role they play in supporting their families.

Code on Social Security in 2020

Recognizing the growing importance of the gig economy, the government introduced the Code on Social Security in 2020. This landmark legislation brings gig workers under the ambit of labour laws for the first time. It paves the way for social security schemes covering health, maternity, education, provident funds, and other benefits. The Code also mandates the creation of a National Social Security Board to oversee the implementation of these schemes.

LEGISLATION ON GIG WORK

Rajasthan has become the **first state in the country to pass a bill** for the welfare of lakhs of gig workers earning their livelihood through online platforms.

This bill aims to address the lack of protection and benefits for gig workers, who were previously classified as "partners" rather than employees in companies like Ola, Uber, Swiggy, Zomato, and Amazon.

Earlier, the Code on Social Security, 2020 mandated social security funds for gig workers, including life, disability, health benefits, and more

- **Key Features:**
  - **Registration of Gig Workers:**
    - The bill mandates the registration of all gig workers with the state government to bring them under the ambit of labor regulations.

- The state government will maintain a comprehensive database of all gig workers operating in Rajasthan.
- Each gig worker will be assigned a unique ID, which will facilitate tracking their employment history and entitlements.

- **Access to Social Security Schemes:**
  - Gig workers will be granted access to a range of social security schemes.
  - These schemes may include health insurance, accident coverage, and other welfare measures to provide financial support during emergencies.
- **Grievance Redressal Mechanism:**
  - The bill ensures that gig workers have the right to be heard and address any grievances they may have.
  - This provision seeks to protect the rights of gig workers and provide them with a platform to resolve work-related issues.
- **Establishment of Platform-Based Gig Workers Welfare Board:**
  - This board will be responsible for overseeing the welfare and rights of gig workers in the state.
  - Welfare Board — comprising State officials, five representatives each from gig workers and aggregators, and two others ("one from Civil Society and another who evince interest in any other field").
    - At least one-third of the nominated members should be women.
  - This representation aims to ensure that the interests of both parties are considered when making decisions related to welfare and regulation.
- **Platform-Based Gig Workers Fund and Welfare Fee:**
  - The bill introduces a "Platform-Based Gig Workers Fund and Welfare Fee" to finance the social security measures for gig workers.
  - The fund will be utilized to provide financial support and welfare benefits to gig workers during challenging times.
- **Fee Levied on Aggregators:**
  - Aggregators will be required to pay a fee for each transaction involving a platform-based gig worker.
  - The specific percentage of the fee will be determined by the state government to contribute to the welfare fund.
- **Penalties for Non-Compliance:**
  - The bill includes provisions for penalties in case of non-compliance by aggregators.
  - Aggregators failing to pay the welfare fee on time will be charged an interest rate of 12% per annum from the due date.
  - The state government can impose fines of up to Rs 5 lakh for the first contravention and up to Rs 50 lakh for subsequent violations of the Act by aggregators.

Challenges Remain

While the gig economy offers opportunities, it's not without its challenges. Low wages, unequal gender participation, and limited avenues for upward mobility are common concerns. Gig workers often lack the benefits and security enjoyed by traditional employees, leading to protests and demands for better working conditions.

The Road Ahead

To ensure a brighter future for gig workers, several steps can be taken. **NITI Aayog suggests fiscal incentives** for businesses that prioritize female participation in the gig economy. Retirement benefits, income support, and paid sick leave are crucial measures that can provide much-needed security and stability.

The gig economy is a double-edged sword. It offers flexibility and independence, but also raises concerns about security and fair treatment. As India embraces this new work model, it's crucial to strike a balance between opportunity and protection, ensuring that the gig economy empowers, not exploits, its workforce. By providing social security, promoting fair wages, and fostering opportunities for growth, India can harness the potential of the gig economy to create a more inclusive and prosperous future for all.

SOCIAL SECURITY

The social sector and poverty share a deep connection, mainly encompassing those Below Poverty Line (BPL) and those marginalized from mainstream development. This segment includes the underprivileged, consistently on the disadvantaged side, comprising the poor, backward classes, and scheduled castes/tribes. Among them are landless individuals, small and marginal farmers engaged in informal sector jobs, barely sustaining themselves on a day-to-day basis. This vulnerable section is prone to exploitation, lacks a voice, and can be referred to as 'silent sufferers' or 'mere spectators,' unaware that India is now one of the fastest-growing economies.

Despite the evident challenges, the government has adopted a **three-pronged strategy to address social sectors**:

Broad Targeting

Under broad targeting, ambitious programs with sub-programs aim for overall and comprehensive national development. Examples include:

- **Pradhan Mantri Awas Yojana (Rural) & (Urban)**
- **Mid-day Meal scheme**
- **Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGA)**

- **Swachh Bharat Abhiyan (Rural) & (Urban)**
- **Atal Mission for Rejuvenation and Urban Transformation (AMRUT)**
- **Integrated Child Development and Services (ICDS)**
- **National Rural Health Mission (NRHM)**

Notably, the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGA), conceived by the Belgian economist Jean Dreze, stands out. Enacted at the national level, this groundbreaking project guarantees 100 days of unskilled wage employment to one person in every rural household during the lean season of agricultural activities. Despite global acclaim, critics express concerns about potential long-term effects, such as increased minimum wages, rising costs, and potential inflation.

Narrow Targeting

The government is also employing narrow targeting strategies, including:

- **Wage Employment Scheme** (primarily through Mahatma Gandhi NREGA)
- **Self-Employment Schemes** (primarily through Deendayal Antyodaya Yojana - National Rural Livelihoods Mission (DAY-NRLM) in rural areas and Deendayal Antyodaya Yojana-National Urban Livelihoods Mission (DAY-NULM) in urban areas)
- **Food security** (primarily through NFSA 2013, Antodaya Anna Yojana, Pradhan Mantri Garib Kalyan Ann Yojana)

Social Security

Social Security is Provided Through Various Programs, Such as

- **Ayushman Bharat- Pradhan Mantri Jan Arogya Yojana**
- **Pradhan Mantri Shram Yogi Maan-dhan Yojana (PM-SYM)**
- **POSHAN Abhiyan**
- **Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)**
- **Pradhan Mantri Suraksha Bima Yojana (PMSBY)**
- **Pradhan Mantri Jan Dhan Yojana**
- **Prime Minister Street Vendor's Atma Nirbhar Nidhi (PM SVANidhi)**
- **Atal Pension Yojana (APY)**

These initiatives align with the government's commitment to addressing health, nutrition, and financial inclusion challenges. However, challenges persist in effective implementation, awareness, and monitoring.

CONCLUSION

India's struggle against poverty, inequality, and unemployment remains a multifaceted fight. Despite strides in social programs and economic growth, deep disparities persist. Bridging the gap demands sustained investment in education, healthcare, and rural development alongside policies fostering inclusive job creation and equitable wealth distribution. Only through a multi-pronged attack can India truly rise, leaving no one behind in its ascent.

Economic Planning in India

4

INTRODUCTION

Economic planning guides an economy towards specific goals. It's like drawing a map for resources – Labour, money, materials – to achieve desired outcomes like growth, stability, and social welfare. Governments use tools like fiscal policies, investments, and regulations to steer the economy along this planned path, influencing markets but not replacing them entirely.

Economic planning in India, is integral since its post-independence era, and involves a systematic approach to guide and control the nation's economic development. Formalized with the establishment of the Planning Commission in 1950, India's planning process outlines specific goals and strategies through Five-Year Plans.

What is Bombay Plan?

- The Bombay Plan, formulated during World War II, outlined proposals for India's economic development after gaining independence from the United Kingdom in 1947.
- Crafted by prominent industrialists, including J.R.D. Tata, Ghanshyam Das Birla, and others, the plan advocated for state intervention in the economy to promote import substitution industrialization.
- It proposed doubling agricultural output and achieving a five-fold growth in the industrial sector, with a planned investment of 100 billion Rupees over 15 years. Notably, 44.8% of this investment was allocated to industry.
- A fundamental tenet of the Bombay Plan was the belief that economic growth required government intervention and regulation. Given the perceived inability of nascent Indian industries to compete in a free-market environment, the plan recommended safeguarding indigenous industries from foreign competition in local markets. Other key points included active government involvement in deficit financing, equitable growth planning, a shift from agrarian to industrial society, and, if necessary, the establishment of critical industries as public sector enterprises.
- The plan's enduring influence and iconic status in Indian historiography highlight its role as an indicator of the developmental aspirations of the domestic capitalist class during the postwar period.

Originally rooted in the Bombay Plan of 1944, economic planning has evolved to address diverse objectives such as poverty alleviation, industrialization, and social welfare. While the Planning Commission has given way to the NITI Aayog, economic planning in India continues to strike a balance between market forces and strategic state intervention, emphasizing sustainable development and global competitiveness.

Indian Economy During Colonial Rule

The British economic policies had a profound impact on India, transforming it into a colonial economy with distinct characteristics. The key features of the colonial structure included:

- **Integration into the World Capitalist System:** Colonialism resulted in the intricate integration of the Indian economy into the global capitalist system, albeit in a subservient role. India's economic interests were subordinated to those of Britain, which led to a unique production structure and an international division of labor that favoured British industry.
- **Appropriation of Economic Surplus:** The process of economic development in India was hindered by the limited size and utilization of the economic surplus or savings for investment and expansion (net savings from 1914 to 1946 were merely 3% of GNP). A significant portion of India's economic surplus was appropriated by the colonial state, indigenous landlords, and moneylenders, with only a fraction allocated to the development of agriculture, industry, or social infrastructure.
- **Regressive Tax System and "Drain":** The tax system in colonial India was regressive, burdening peasants while sparing bureaucrats, landlords, and merchants. Additionally, the colonial state engaged in "Drain," a unilateral transfer of social surplus and potential investable capital from India to Britain.
- **British-Determined Policies:** India's economic policy was dictated by Britain, prioritizing the interests of the British economy and capitalist class. Notably, state support for Indian industry and agriculture was denied, in contrast to the active support provided by most capitalist countries during their early stages of development.

Hence, colonialism resulted in the comprehensive stagnation and lack of development in the Indian economy. The economic scenario at the time of independence can be summarized as follows:

- At the time of independence, the agrarian structure shaped during the British colonial era was marked by the **dominance of landlords, moneylenders, merchants, and the colonial state.** These entities claimed over half of the agricultural production, primarily concentrating on collecting land revenue, with little investment in the improvement of agricultural practices.
- In the 19th century, the swift deterioration of Indian handicrafts and artisanal industries were driven by two primary factors:
  - First, the **surge of less expensive goods** from Britain, along with the implementation of **free trade policies** in India, resulted in heightened competition.
  - Second, the European countries, including Britain, enforced substantial **import duties on Indian goods**, essentially shutting European markets to Indian manufacturers after 1820. The distressed artisans, who faced a **lack of alternative employment**, transitioned to agriculture, causing a notable sub-division and fragmentation of land.
- The 19th-century industrial development was confined to specific sectors such as cotton, jute, coal, and tea, with later expansion into sugar, cement, and paper during the 1930s. However, the absence of heavy or capital goods industries, crucial for rapid and independent industrial development, posed a serious weakness.
- The industrial and financial sectors were predominantly under the influence of foreign capital, with British firms exerting control over key industries and foreign trade. This British capitalist influence extended to numerous Indian-owned companies through **managing agencies.**

At the time of Independence, India inherited a colonial legacy of economic underdevelopment, widespread poverty, high illiteracy rates (84%), prevalent diseases, and stark social inequality. Colonialism resulted in the underdevelopment and impoverishment of the population, particularly the peasantry and artisans.

Indian Economy After Independence

- Post-British rule, Indian leaders united to construct the nation on the **principles of nationalism, secularism, and democracy,** with a goal of rapid economic development within a democratic political framework.
- Despite these aspirations, **structural distortions** from colonialism posed challenges to achieving self-sustained growth.
- Leaders, including Jawaharlal Nehru, sought a suitable economic system for India. While sympathetic to socialism, Nehru rejected the extreme Soviet model, favoring a balanced alternative that **avoided the extremes of both capitalism and socialism.**
- This vision envisioned a socialist society with a robust public sector, private property, and democracy, combining individual freedom with equality.
- Reflected in policies like the **Industrial Policy Resolution of 1948** and the **Directive Principles** of the Indian Constitution, this approach encouraged private sector participation in the planned economy.
- The establishment of the **Planning Commission** in 1950, chaired by the Prime Minister, marked the onset of the era of five-year plans.

Industrial Policy Resolution of 1948

- In April 1948, India introduced its inaugural Industrial Policy Resolution (IPR), which placed a significant emphasis on the economy's continuous growth in production and equitable distribution.
- It advocated for an active role of the state in industrial development, which marked the **initiation of a mixed economy.**
- The IPR of 1948 outlined the respective roles of the public and private sectors in India and **categorized industries** into four main groups based on the extent of government or private sector involvement:
  - **State Monopolies:** This category encompassed the manufacturing of arms and ammunition, atomic energy, and railway transport, exclusively under the government's monopoly.
  - **Basic Industries:** Industries like coal, iron and steel, shipbuilding, aircraft manufacturing, telephone, telegraph, wireless, and mineral oils, crucial for economic development, were under the central government. However, existing private companies in these sectors were permitted to continue.
  - **Regulated Industries:** Sectors such as automobiles, heavy machinery, chemicals, fertilizers, sugar, paper, cement, cotton, woolen textiles, etc., were subject to government regulation (pricing, production quantity, etc.) due to their importance to the masses.
  - **Private Industries:** All other industries were open to operation by the private sector and cooperatives.
- The IPR of 1948 aimed to establish the groundwork for a mixed economy, fostering the co-existence of both public and private enterprises to accelerate the pace of industrial development in India.

Different Economic Systems

Capitalist Economy

- In a capitalist economy, the means of production (such as factories and businesses) are predominantly **owned and operated by private individuals or corporations.** Economic decisions, including what to produce and how to allocate resources, are driven by market forces and the profit motive.

Features

- Private ownership of property and businesses.
- Free market competition.

- Minimal government intervention in economic affairs.
- Profit as a primary incentive for production.

Socialist Economy

- In a socialist economy, the means of production are often owned or controlled by the state or the community as a whole. The primary goal is to achieve social and economic equality. Economic planning plays a significant role, and there may be central planning to allocate resources.

Features

- Public or collective ownership of major industries.
- Centralized economic planning.
- Social equality and collective welfare act as the key goals.
- Limited private ownership in specific sectors.

Mixed Economy

- A mixed economy combines elements of both capitalism and socialism. It incorporates private enterprise and markets, but the government also plays a role in regulating and managing certain aspects of the economy, such as public services and social welfare.

Features

- Co-existence of private and public ownership.
- Market forces determine some economic activities.
- Government intervention in specific sectors for public welfare.
- Balancing individual freedom and social welfare goals.

Open Economy

- In an open economy, a country engages in international trade and economic transactions with other nations.
- It allows the flow of goods, services, capital, and sometimes labor across its borders.
- Open economies typically have fewer trade restrictions, such as tariffs or import/export quotas

Closed Economy

- In a closed economy, a country does not engage in significant international trade or economic transactions.
- It relies on its domestic production and consumption without significant interaction with foreign markets.
- Closed economies may have strict trade barriers and restrictions, limiting the flow of goods and services across borders.

Most real-world economies fall somewhere between being completely open and completely closed. The degree of openness is often measured by the level of international trade, foreign direct investment, and capital flows.

The choice between an open or closed economy depends on various factors, including economic policy goals, geo-political considerations, and the preferences of policymakers. Countries may transition from being more closed to more open, or vice versa, based on changing circumstances and policy decisions.

Economic Planning

- Economic planning involves the strategic allocation of resources in a systematic manner to attain predetermined objectives, ensuring optimal utilization of available resources.
- The underlying philosophy of planning is that the welfare of citizens cannot be solely guaranteed by markets and price systems. In addition to these mechanisms, there are economic necessities such as investing in infrastructure and public goods like transportation, which benefit the entire society.
- The significance of economic planning lies in its ability to guide and structure a country's economic development, ensuring sustainable growth and addressing socio-economic challenges.

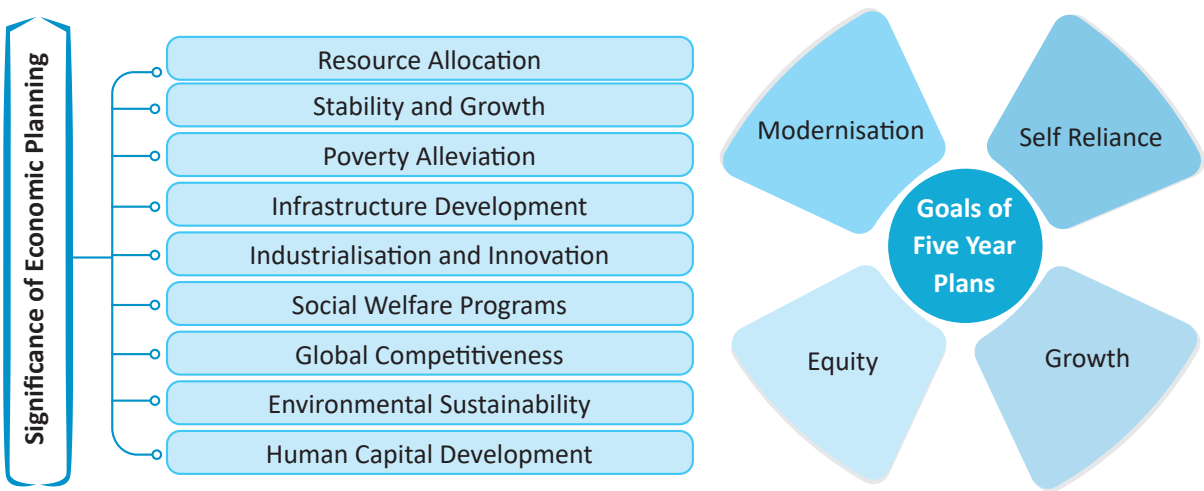


Fig. 4.1: About Economic Planning

- In essence, economic planning serves as a compass for a nation's development journey, guiding policies and strategies to achieve balanced, inclusive, and sustainable growth.

Types of Economic Planning

Imperative Planning	- It is also known as authoritative planning by direction or command. - One central authority to decide all the aspects of planning. - All available resources are utilized to their maximum potential to achieve the plan's objectives. - Practiced in socialist economies.
Indicative Planning	- It is also known as inducement planning, this approach is flexible in nature. - The government acts as a facilitator, encouraging the private sector's participation in the economy while simultaneously regulating it to achieve specific targets. - This planning method is generally practiced in a mixed economy.
Perspective Planning	- Spans a long period, typically 15-20 years, though not with a single plan covering the entire duration. - Operationalized through Five Year Plans (FYPs) and Annual Plans, - The planner establishes a perspective plan outlining the desired direction for the economy. - NITI Aayog has adopted this type of planning structure.
Decentralized Planning	- Implementation of the plan starts at the grassroots level and is formulated by the Centre in collaboration with State authorities. - Prices of goods are determined through market mechanisms.
Fixed Plan	- Fixed for 4, 5, 6, or 7 years, with physical targets and a total outlay determined.
Rolling Plan	- Under the Rolling Plan, three new plans are prepared and acted upon each year: • A plan for the current year, including the annual budget. • A plan for a fixed number of years (e.g., 3-5 years), revised annually based on economic conditions. • A perspective plan for 10, 15, or 20 years. - The Plan, introduced by the Janta Government in 1978 for the 1978-83 period, was abandoned midway due to a change in government.
Core Plan	- In this approach, the planning authority solicits projected revenue estimates from the States. - Based on these estimates, the planning authority determines the expenditure for the State annual plans, preventing the diversion of funds from priority sectors to non-planned accounts.

Need For Economic Planning

- Challenging economic conditions prevailed at the time of independence.
- The absence of a substantial private sector presence in the economy.
- Necessity for the effective mobilization and efficient allocation of resources.
- Uneven development of industries.
- Additionally, the initiation of planning by the USSR exerted international influence.

Evolution of Economic Planning in India

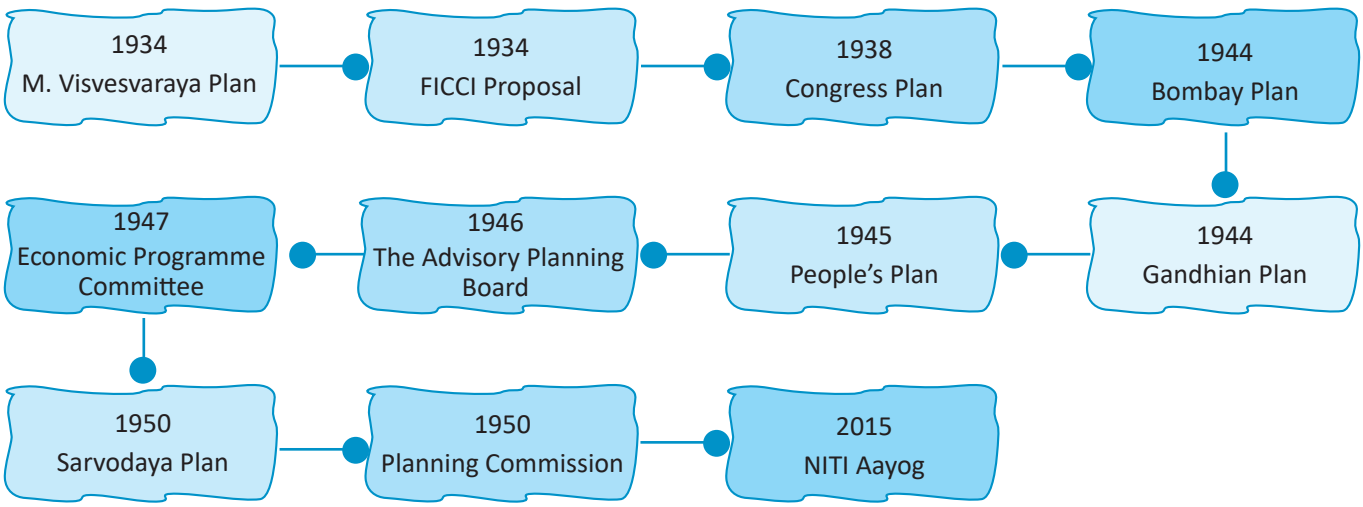


Fig. 4.2: Evolution of Economic Planning in India

- **M. Visvesvaraya Plan:** It stressed the need to transition from agriculture to industrialization and aimed to boost employment in industries, with the target of doubling national income within a decade. In his book titled **"Planned Economy for India" (1934),** the goal of poverty eradication through growth was articulated.
- **FICCI Proposal:** The plan advocated for moving away from laissez-faire and expressed the perspective of the capitalist class. Additionally, it supported the establishment of a National Planning Commission.
- **Congress Plan:** Initiated by Subhash Chandra Bose, the National Planning Committee (1938) was formed, **with J.L. Nehru as its Chairperson.** However, its report was published considerably later in 1949.
- **Bombay Plan:** Sponsored by the top eight industrialists of Bombay, the plan aimed at agricultural restructuring by abolishing the Zamindari system, promoting rapid industrialization, and developing essential and consumer goods, along with small, medium, and cottage industries. The emphasis was on industrialization to alleviate population hardships caused by inflation.
- **Gandhian Plan:** Drafted by Acharya Shriman Narayan Agarwal, this plan highlighted economic decentralization and the promotion of small-scale and cottage industries.
- **People's Plan:** Drafted by M.N. Roy for a ten-year period, this plan prioritized agricultural development and an increase in agricultural production while maintaining a balanced approach with industrialization.
- **Planning Advisory Board:** Established by the interim government of the time, its purpose was to review plans and future projects and provide recommendations for them.
- **Economic Programme Committee:** Established by the All India Congress Committee to create a strategy for balancing private and public partnerships as well as urban and rural economies, this initiative proposed the formation of the Planning Commission.
- **Sarvodaya Plan:** Crafted by Jayaprakash Narayan, it prioritized agriculture, small and cottage industries, advocated for independence from foreign technology, and emphasized the importance of land reforms. Additionally, it recommended decentralized and participatory planning.
- **Planning Commission:** Charged with evaluating all the country's resources and formulating plans for their effective and balanced utilization, it was led by Prime Minister J.L. Nehru as its first Chairman.
- **Niti Aayog:** Subsequently replacing the Planning Commission, it now operates as a think tank.

Planning in India

- India's five-year plans did not specify precise quantities for each type of good and service to be produced. Such a detailed approach is **neither feasible nor essential** (as exemplified by the failed attempt of the former Soviet Union to achieve this).
- Instead, the focus was on delineating sectors where planning played a significant role, such as power generation and irrigation, while allowing the market to determine the specifics for the remaining sectors.
- The Planning Commission used to propose funding allocations for various developmental expenditures, including schemes outlined in each Five-Year Plan.

Objectives of Planning

- **Economic Growth:** Economic growth denotes the increase in a country's capacity to produce goods and services (GDP) domestically. The production of a greater quantity of goods and services is essential for the people of India to experience a more affluent and diverse life.
- **Modernization:** The augmentation of goods and services production necessitates the adoption of new technology, known as modernization. However, modernization encompasses more than just technological advancements; it also includes changes in societal perspectives, such as the acknowledgment of equal rights for women.
- **Self-Reliance:** A nation can foster economic growth and modernization by utilizing its own resources or importing resources from other countries. The initial seven five-year plans (FYPs) prioritized self-reliance, emphasizing the avoidance of importing goods producible within India. This policy aimed to reduce dependence on foreign countries, particularly for essential items like food, reflecting the concern that reliance on foreign technology and capital could jeopardize India's sovereignty.
- **Equity:** While growth, modernization, and self-reliance are crucial, they alone may not enhance people's quality of life. It is imperative to ensure that the benefits of economic prosperity extend to the impoverished sections rather than being exclusive to the affluent. Thus, in addition to growth-related goals, achieving equity is essential. Every Indian should have access to basic necessities like food, adequate housing, education, and healthcare, and efforts should be made to diminish wealth inequality.

STRATEGIES OF PLANNING

Planning in The Pre-1991 or Pre-reforms Era

- Between 1950 and 1990, our nation leaned towards a more prominent role for the public sector, accompanied by regulated private sector involvement.
- The formulation of Five-Year Plans (FYPs) during this period was guided by the following fundamental strategies:
  - Emphasis on the public sector
  - Controlled expansion of the private sector

- Development and establishment of heavy industries such as iron and steel
- Promotion of small-scale industries
- Adoption of inward-looking trade strategies
- Imposition of various restrictions on foreign capital, with enforcement of the Foreign Exchange Regulation Act for its regulation

❑ Several planning models were adopted based on these strategies, among them:

Harrod-Domar Model (Implemented in The 1st FYP)

❑ It highlighted the dual character of capital accumulation, emphasising its role in increasing national income (demand-side role), Its contribution to enhancing production capacity (supply-side role).

❑ The determination of the rate at which net investment should increase to achieve a long-term equilibrium in full employment depends on the planners, balancing the demand and supply sides.

❑ The determination of the rate at which net investment should increase to achieve a long-term equilibrium in full employment depends on the planners, balancing the demand and supply sides

Nehru-Mahalanobis Model (Implemented in The 2nd FYP)

❑ This approach, rooted in a **two-sector model** comprising Consumer Goods and Capital Goods sectors, prioritized investment in heavy industries to drive industrialization for rapid economic development.

❑ Inspired by the Russian strategy, it aimed at achieving self-reliance and overcoming capital constraints.

❑ Adopted in the 2nd FYP, this strategy persisted until the 5th FYP, representing a long-term vision.

Gandhian Plan

❑ Drafted by **Acharya Sriman Narayan Agarwal in 1944,** the 'Gandhian Model' focused on two fundamental objectives:
- Elevating the material and cultural standards of the masses.
- Providing a minimum standard of living.

❑ The strategy emphasized the scientific development of agriculture and the rapid growth of cottage and village industries. Consequently, it prioritized **employment-oriented planning** over the production-oriented planning of the Nehru-Mahalanobis strategy.

Rao-Manmohan Model

The term "Rao-Manmohan Model" refers to the economic reforms implemented in India during the early 1990s, often associated with **Prime Minister P.V. Narasimha Rao and his Finance Minister, Dr. Manmohan Singh.** These reforms marked a significant departure from the previous socialist economic policies and introduced measures to liberalize and open up the Indian economy. The key features of the Rao-Manmohan Model include:

Liberalization

❑ The model aimed to reduce the role of the state in the economy and promote market-oriented reforms. It involved dismantling the License Raj, which had imposed stringent controls and regulations on businesses.

Globalization

❑ The integration of the Indian economy with the global economy was a crucial aspect. Trade barriers were reduced, and foreign direct investment (FDI) was encouraged to attract capital and technology from abroad.

Privatization

❑ The government initiated the privatization of state-owned enterprises to enhance efficiency and competitiveness. This involved selling shares of public sector companies to private investors.

Financial Sector Reforms

❑ The financial sector underwent significant changes, including the liberalization of interest rates and the introduction of reforms in banking and capital markets.

Stabilization Measures

❑ To address the balance of payments crisis, the government implemented stabilization measures, including currency devaluation and fiscal consolidation.

Amartya Sen Model

Amartya Sen is an Indian economist and philosopher who has made significant contributions to development economics and welfare economics. His work emphasizes a broader understanding of development that goes beyond traditional measures like GDP growth. Here are some key aspects associated with Amartya Sen's approach to development:

❑ **Capability Approach:** Amartya Sen is best known for his capability approach, which focuses on individuals' capabilities and opportunities to lead lives they value. Instead of solely relying on income or material wealth, Sen argues for assessing people's well-being based on their ability to function in various aspects of life.

❑ **Human Development Index (HDI):** Sen's ideas influenced the development of the Human Development Index, a composite index that considers not only income but also life expectancy and education. HDI provides a more holistic measure of a country's development.

❑ **Social Choice Theory:** Sen has contributed to social choice theory, exploring how individual preferences

can be aggregated to make collective decisions. He has highlighted the importance of considering fairness, equity, and individual freedoms in such decision-making processes.

- **Focus on Freedoms:** Sen emphasizes the importance of enhancing people's freedoms and capabilities. He argues that development should be seen as a process of expanding substantive freedoms, enabling individuals to lead lives they value.
- **Participatory Development:** Sen advocates for participatory approaches to development, where people have the opportunity to be actively involved in shaping the decisions that affect their lives.

Note: These terms may be used informally and are not standard economic models.

Planning in The Post-1991 or Post-Reforms Phase

- Due to the policies in place until 1991, India experienced an increase in fiscal and revenue deficits.
- The country's dependence on imports, coupled with a lack of significant exports, led to a Balance of Payments crisis.
- Stagnation, high inflation, and external factors like the Gulf crisis further exacerbated the situation, resulting in rising prices.
- Consequently, India adopted a New Economic Policy:
  - Promotion of the private sector and facilitation of a free-market environment.
  - Encouragement of foreign inflows through Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII).
  - Export received significant promotion, and there were minimal restrictions on imports.
  - There was a focus on promoting the Public-Private Partnership (PPP) model.
  - Furthermore, the policy of Liberalization, Privatization, and Globalization (LPG) was adopted during the 8th Five-Year Plan (1992-97).

Planning Commission

- The Planning Commission, while no longer active, played a crucial role in policymaking and governance in India.
- It was established through a Government of India Resolution in March 1950, its primary objectives were to elevate the living standards of Indians by effectively utilizing the country's resources, increasing production, and creating employment opportunities for all in the service of society.
- Pandit Nehru served as the first Chairman of the Planning Commission.
- The functions of the Planning Commission encompassed several key aspects:
  - Assessing the material, capital, and human resources of the country, including technical employees, and exploring possibilities for augmenting deficient resources concerning the nation's needs.
  - Devising a plan for the most productive and balanced utilization of the country's resources.
  - Defining stages, based on priority, for plan implementation and proposing resource allocations for each stage's successful completion.
  - Identifying factors that could hinder economic development.
  - Determining conditions necessary for the successful execution of the plan within the prevailing socio-political situation of the country.
  - Specifying the nature of the mechanism required to ensure the successful implementation of each plan stage in all its aspects.
  - Periodically evaluating the progress achieved in plan implementation and recommending policy adjustments and measures essential for success.
  - Making necessary recommendations regarding economic conditions, policies, measures, or development programs relevant to the execution of these functions.

Five-year Plans

- The initiation of planned economic development in **India traces back to 1951** with the commencement of the First Five-Year Plan.
- However, theoretical groundwork began earlier, preceding the country's independence. Various efforts, such as the establishment of the **National Planning Committee in 1938** by the Indian National Congress, The Bombay Plan and the **Gandhian Plan in 1944, the People's Plan in 1945,** and the **Sarvodaya Plan in 1950,** laid the foundation for this development.
- The Five-Year Plans (FYPs) were comprehensive national economic programs initially implemented by Joseph Stalin in the Soviet Union in the late 1920s. Many countries, both communist and capitalist, including China and India, adopted these plans. However, India discontinued the FYPs in 2017, while China transformed its Eleventh FYP into a guideline from 2006 to 2010, indicating a more hands-off approach by the central government.
- After gaining independence, India initiated its First Five-Year Plan in 1951, guided by the socialist principles of Prime Minister Jawaharlal Nehru.

- The **Planning Commission,** established in March 1950, played a vital role in efficiently assessing and utilizing the country's resources.
- In the initial eight plans, there was a strong focus on expanding the public sector with significant investments in basic and heavy industries. However, from the Ninth Plan onward, beginning in 1997, a noticeable shift occurred, moving away from a pronounced emphasis on the public sector.
- The overall approach to planning in the country gradually transitioned towards being indicative in nature.

IGNITE YOUR MIND

The world bank has been pessimistic about India's growth forecast due to supply chain disruptions, inflation and geopolitical tensions. Several impediments in terms of distorted social factors, for instance, large scale poverty, income inequality pose risk as well. Do you think the goal of 5 trillion $ economy is still a long road to travel?

Five Year Planning Development in India

Five Year Plan (FYP)	Target Growth	Actual Growth	Description
1st Five Year Plan (1951-56)	2.1%	3.6%	❑ It drew inspiration from the **Harrod-Domar Model.** ❑ In 1952, the **Community Development Programme** was launched. ❑ The onset of the first five-year Plan was marked by challenges such as an **influx of refugees, severe food shortage, and rising inflation.** ❑ **K.N Raj,** a renowned economist was one of the main architects. ❑ The plan **prioritized** • **agriculture,** in view of import of food grain in large-scale to achieve food security. • **price stability,** • **Irrigation** (River Valley Projects- Bhakra Nangal, Damodar Valley, Hirakund add so on were undertaken) • **Rural development,** • **power, and transport.** ❑ Successful implementation was attributed to favorable harvests in the final two years, achieving objectives like **refugee rehabilitation, food self-sufficiency, and price control.**
2nd Five Year Plan (1956-61)	4.5%	4.3%	❑ The application of the simple aggregative Harrod-Domar Growth model guided overall projections, while **Prof. PC Mahalanobis** devised the resource allocation strategy (also known as the **Mahalanobis Plan**). ❑ It was based on the Nehru-Mahalanobis **Strategy** which was articulated by J.L. Nehru's Vision and P.C. Mahalanobis. ❑ The second plan unfolded in a context of economic stability, leading to a reduced emphasis on agriculture. ❑ Instead, it concentrated on **rapid industrialization,** especially in heavy and basic industries. ❑ The plan proposed substantial imports facilitated by **foreign loans**. ❑ The **Industrial Policy of 1956** aimed at establishing a socialist pattern of society through economic policies. Despite encountering challenges like a severe forex shortage and a notable price rise (around 30%), the second five-year plan **achieved moderate success** compared to the preceding plan.
3rd Five Year Plan (1961-66)	5.6%	2.8%	❑ At its inception, there was a belief that the Indian economy had entered a take-off stage, aiming to transform into a **'self-reliant' and 'self-generating'** economy. ❑ The plan focused on both **heavy industrialization and food grain production.** ❑ Drawing from the experiences of the first two plans, agriculture received top priority to support exports and industry. However, unforeseen events such as the **Chinese aggression in 1962, Indo-Pak war in 1965,** and severe **drought in 1965-66** led to a complete failure in achieving the plan targets. ❑ India faced a **severe foreign exchange crisis**, leading to borrowing from the IMF.

Five Year Plan (FYP)	Target Growth	Actual Growth	Description
			❑ The **rupee was devalued** for the first time in June 1966, although not technically during the 3rd FYP. ❑ The country also experienced **acute food shortage**, and the United States exported food grains to India in exchange for Indian rupees, popularly known as **PL-480** under section 480 of the U.S. Public Law. ❑ This situation further delayed the finalization of the 4th FYP.
Three Annual Plans (1966-69)			❑ Even though the draft of the 4th FYP was ready, the Annual Plan was formulated for the next three years due to worsening financial conditions. This three-year period was criticized and termed as a **"Plan Holiday."** ❑ During these three Annual Plans, a **New Agricultural Strategy** was implemented: • encompassing widespread distribution of **High-Yielding Variety (HYV)** seeds under the broader scope of the Green Revolution, • **exploitation of irrigation** potential, • extensive **use of fertilizers,** and • a focus on **soil conservation.** ❑ These plans played a vital role in stabilizing the economy, absorbing the shocks generated during the Third FYP.
4th Five Year Plan (1969-74)	5.7%	3.3%	❑ Adhering to the **Gadgil strategy** with a primary emphasis on agricultural growth to facilitate progress in other sectors and move towards self-reliance, the initial two years of the plan witnessed record production. ❑ However, the last three years fell short of the target due to poor monsoon conditions. ❑ Notably, this plan marked the first-time **prioritization of social justice.** ❑ Significant developments during this plan period included **Bank Nationalization, abolition of privy purses to princes, the outcomes of the Green Revolution, and the Indo-Pak war.** ❑ **Family planning** emerged as another crucial aspect of this plan. ❑ The **influx of Bangladeshi refugees** before and after the 1971 Indo-Pak war presented a major challenge.
5th Five Year Plan (1974-79)	4.4%	4.8%	❑ It was formulated by **D.P. Dhar** with the aim of achieving two primary objectives: **poverty eradication** (Garibi Hatao) and the attainment of **self-reliance.** ❑ Several programs were initiated, including the **Minimum Needs Programme** designed to provide basic necessities and enhance living standards. ❑ The **Twenty-point Programme,** established in 1975, aimed to improve the quality of life for people, particularly those belonging to Below Poverty Line (BPL) families. ❑ The plan's key strategies involved promoting a high rate of economic growth, ensuring better income distribution, and fostering a significant increase in the domestic savings rate. ❑ However, with the declaration of an emergency in 1975, the plan was **prematurely terminated.**
Rolling Plan (1978-80)			❑ There were 2 Sixth Plans. Janta Govt. put forward a plan for 1978-1983 emphasising on employment. ❑ Unfortunately, this plan was also abandoned following another change in government in 1980.
6th Five Year Plan (1980-85)	5.2%	5.66%	❑ Emphasis was placed on increasing national income, modernizing technology, and ensuring a continuous decrease in poverty and unemployment during this plan. ❑ There was a shift from industrialization toward infrastructure development, with programs such as the **National Rural Employment Programme, Integrated Rural Development Programme, and Village and Small Industries Development Programme** focusing on employment generation. ❑ The Energy Sector received the highest financial allocation during this plan.

Five Year Plan (FYP)	Target Growth	Actual Growth	Description
7th Five Year Plan (1985-90)	5%	6.%	❑ The plan prioritized rapid growth in food grain production, increased employment opportunities, and enhanced productivity within the planning framework. ❑ It marked the beginning of a long-term fiscal policy, introducing a three-year export-import policy for the first time. ❑ Often referred to as the Infrastructure Plan, it gave due importance to the **Import Substitution strategy,** signaling the economy's initial steps towards gradual liberalization.
Annual Plans (1990-92)			❑ The Eighth Plan faced delays in its commencement in 1990 due to the rapidly changing political situation at the center, treating the years 1990-91 and 1991-92 as Annual Plans. ❑ Eventually, the Eighth Plan was formulated for the period 1992-1997. ❑ The BOP crisis in 1991 and conditions set by the IMF brought significant changes to the Indian economy, leading to the two-year delay of the eighth FYP.
8th Five Year Plan (1992-97)	5.6%	6.8%	❑ The **policy of Liberalization, Privatisation, and Globalization (LPG)** was undertaken during this period, marking a shift in the country's economic growth model. ❑ The plan, based on the **Rao-Manmohan Singh model** of liberalization, introduced structural reforms and recast the planning model from imperative and directive (hard) to indicative (soft) planning. ❑ Major outcomes included rapid overall economic growth, a high rate of growth in agriculture, manufacturing, and allied sectors, increased imports and exports, and improvement in trade and current account deficit. ❑ However, social spending was neglected during this plan.
9th Five Year Plan (1997-2002)	6.5%	5.4%	❑ The plan was formulated with a focus on four crucial dimensions: **enhancing the quality of life, generating productive employment, achieving regional balance, and promoting self-reliance.** ❑ Special emphasis was placed on **agriculture and rural development.** ❑ Initiatives like **Swarnajayanti Gram Swarojgar Yojana (SGSY)** in 1999 and **Pradhan Mantri Gram Sadak Yojana (PMGSY)** in 2000 were introduced. ❑ Additionally, the plan marked the initiation of privatization in public sector units, building on the disinvestment efforts from the previous plan.
10th Five Year Plan (2002-07)	8%	7.6%	❑ The primary objectives of the plan included: • **Reduction of the poverty ratio by 5%** points by the end of the plan period, • **Narrowing gender gaps** in literacy and wages by at least 50%, • **Lowering the decadal rate of population** growth between 2001 and 2011 to 16.2%, • Achieving an **infant mortality rate** of 45 per 1,000 births by 2007 and 28 per 1,000 births by 2012, • Minimizing overall capital outflow. • Increase in the GDP growth rate to 8% per year, • Elevating **literacy rates** to 75% within the plan period. • Augmenting **forest and tree cover** to 25% by 2007 and 33% by 2012, • Boosting **domestic savings, foreign investment, and foreign exchange.** ❑ Ensure **universal access to primary education,** offer **high-quality employment opportunities** for the growing labor force, and achieve the cleaning of all major polluted rivers by 2007 and other designated stretches by 2012. ❑ **Result:** • Severe drought in 2002-03. • Initiation of **NREGA (National Rural Employment Guarantee Act)** and the **National Rural Health Mission.**

Five Year Plan (FYP)	Target Growth	Actual Growth	Description
11th Five Year Plan (2007-12)	9%	8%	❑ Introduced during the emerging **Global Financial Crisis (2008),** the plan had the following key objectives: • Increase overall GDP growth from 7% to 9%. • Raise the agriculture sector growth to 4%. • Enhance the **real wage rate** of unskilled workers by 20%. • Improve the literacy rate for individuals aged 7 years or above to 85%. • Attain a sex ratio for the age group 0-6 of 935 by 2011-12 and 950 by 2016-17. • Expand forest coverage by 5% points. • Achieve a 20% point increase in energy efficiency by 2016-17. ❑ To achieve targets: • **Decrease dropout rates** of children from elementary school from 52.2% in 2003-04 to 20% by 2011-12. • Reduce the **total fertility rate to 2.1%.** • Lower the **infant mortality rate to 28.** • **Halve malnutrition** among children aged 0 to 3 years from its present level. • **Reduce anemia** among girls and women by 50%. ❑ Additionally: • Generate **58 million employment opportunities.** and reduce educated employment to below 5%. • Allocate, for the first time, 30.2% of the total outlay for the **social services sector.** • Ensure that at least 33% of the direct and indirect beneficiaries of all government schemes are women and girl children. • Establish **all-weather road connectivity** to habitations with a population of 1000 and above by the end of 2009. • Connect every village through **telephone** and provide broadband connectivity to all villages by 2012. • Attain WHO standards of **air quality** in all major cities by 2011-12. • The overarching theme of the plan is **"Towards Faster and More Inclusive Growth."**
12th Five Year Plan (2012-17)	8.2%	6.5%	❑ The plan sought to: • attain a 4% growth in agriculture, • reduce poverty by 10 percentage points • achieve faster, sustainable, and more inclusive growth. ❑ The theme was "Faster, More Inclusive, and Sustainable Growth."

Achievements of Five Years Plan

❑ **GDP Growth:**

- **Overall growth:** Five-Year Plans have steered India towards a steady rise in GDP. From a modest 2.1% growth rate during the First Plan (1951-56) to a robust 8.2% during the Eleventh Plan (2007-12), the plans have laid the foundation for a progressively thriving economy.
- **Sectoral shifts:** The focus of plans has shifted over time, from agriculture and heavy industries in the initial years to services and knowledge-based sectors in recent plans. This reflects India's evolving economic structure and changing priorities.

❑ **Poverty Reduction:**

- **Significant decrease:** One of the most notable achievements is the substantial reduction in poverty. From a staggering 55% in 1973-74, the poverty rate has declined to around 22% in 2012, according to official estimates.
- **Targeted programs:** This decline can be attributed to targeted poverty alleviation programs like MGNREGA and Pradhan Mantri Jan Dhan Yojana, implemented under various Five-Year Plans.

❑ **Education and Healthcare:**

- **Literacy boost**: The literacy rate has witnessed a remarkable increase, from 18.3% in 1951 to 74.4% in 2018. This progress is largely due to investments in education infrastructure and initiatives like Sarva Shiksha Abhiyan.
- **Improved healthcare**: Life expectancy has risen significantly, from 37 years in 1951 to 69 years in 2020, reflecting improvements in healthcare facilities and access to essential medical services.

- **Infrastructure Development:**
  - **Connecting the nation:** Five-Year Plans have prioritized infrastructural development, leading to a vast network of roads, railways, and airports. India's National Highway length increased from 19,811 kms in 1950-51 to 1,40,995 in 2021-22
  - **Powering progress:** The total Power Generating Capacity of (utilities & non utilities) has increased from a meagre 1362 MW in 1947 to about 482.23 GW at the end of March, 2022.
- **Technological Advancements:**
  - **Space and nuclear strides:** India has made significant strides in space exploration and nuclear technology under the Five-Year Plans. Some of its noteworthy achievements include launching indigenous satellites and developing nuclear power plants.
  - **Digital push:** Recent plans have emphasized digital infrastructure development and initiatives like Digital India to bridge the digital divide and leverage technology for progress.

Criticisms of Five Year Plan

- **Inefficiency and Slow Implementation:** The planning process was characterized by a lengthy bureaucratic process, leading to delays in the implementation of projects. Inefficiencies in resource allocation and execution hampered the plans' effectiveness.
  - Inability to effectively eradicate poverty, curb the proliferation of black money, ensure employment for all eligible individuals, and complete the implementation of land reforms.
- **Regional Disparities:** Critics argued that the planning process did not adequately address regional disparities. The benefits of economic development were not evenly distributed among states and regions, leading to imbalances. The plan showed inadequacies in addressing income and gender disparities.
- **Lack of Flexibility:** The long-term nature of the Five-Year Plans made them less adaptable to rapidly changing economic scenarios. The plans often struggled to adjust to emerging challenges, global economic shifts, and unforeseen circumstances.
- **Focus on Inputs, not Outcomes:** The Five-Year Plans often focused more on input indicators, such as financial allocations and physical targets, rather than measurable outcomes and impact on socio-economic development. The Plan failed to provide suboptimal quality of educational outcomes.
- **Top-Down Decision-Making:** Decision-making was concentrated at the central level, limiting the involvement of states and local governments in the planning process. This top-down approach was seen as undemocratic and less responsive to the diverse needs of different regions.
- **Rigidity and Centralised Planning:** Centralized approach to planning, with plans being program-driven rather than demand-driven. The plans were often top-down, and the centralized control limited the flexibility needed to respond to dynamic economic changes and regional variations.
- **Changing Economic Paradigms:** By the late 20th century, there was a global shift towards market-oriented economic reforms. The traditional planning model was seen as outdated, and there was a need for a more market-driven and decentralized approach to economic development.
- **Emerging Challenges:** India faced new challenges such as rapid urbanization, environmental issues, technological advancements, and the need for innovation. The traditional planning model struggled to address these emerging challenges effectively.
- **Need for Collaboration and Innovation:** The global trend was moving towards collaborative decision-making, innovation, and flexibility. There was a recognition that India needed a more contemporary institution that could foster cooperative federalism, involve experts, and promote innovation and entrepreneurship.
- **Globalization and Liberalization:** The process of globalization and economic liberalization gained momentum in the 1990s. The Five-Year Plans were seen as incompatible with the principles of market-driven reforms and the opening up of the Indian economy to global trade.

In response to these challenges, NITI Aayog was established to replace the Planning Commission. NITI Aayog was envisioned as a dynamic institution that could address the shortcomings of the Five-Year Plans by promoting **cooperative federalism,** involving states and domain experts, and adopting a more **flexible and outcome-oriented approach** to economic planning.

NITI Aayog

- In line with its reform agenda, the Government of India replaced the Planning Commission with **National Institution for Transforming India (NITI)** Aayog to better align with the nation's needs and aspirations.
- This move signifies a shift towards **cooperative federalism,** encouraging states to collaborate in the national interest.
- Formed on **January 1, 2015,** through a Union Cabinet resolution, NITI Aayog serves as the premier **policy think tank,** providing strategic inputs for the government's long-term policies and programs.
- Distinct from its predecessor, NITI Aayog lacks financial powers for fund allocation and operates as an **advisory body** without binding recommendations.
- Similar to the Planning Commission, it is a **non-constitutional and non-statutory body.**
- The Ministry of Finance now handles fund allocation to states.

- The **Governing Council** of NITI Aayog, headed by the Prime Minister, consists of Chief Ministers of States and Lt. Governors of UTs, replacing the former **National Development Council (NDC)**.
- **Regional Councils** may be established based on specific needs, involving Chief Ministers and Lt. Governors of UTs of the concerned region.
- NITI Aayog's workforce has seen a significant reduction compared to the Planning Commission.
- The staff is organized into two hubs:
  - The **Knowledge and Innovation Hub,** focusing on various sectors and building think tank capabilities, and
  - The **Team India Hub,** serving as an interface between the Central Government and the States.
- NITI Aayog also has offices attached to it, such as
  - The **Development Monitoring and Evaluation office (DMEO),** formed in 2015 by merging the Programme Evaluation Organisation and the Independent Evaluation Office. DMEO **monitors and provides research input** on the schemes, policies, and programs of the Government of India.
  - The **National Institute of Labour Economics Research and Development (NILERD),** established in 1962 during the Planning Commission era, functions as a Central Autonomous Organisation specializing in **research and data collection** related to various aspects of development.

Major Projects Undertaken By DMEO In 2022-23

- Output-Outcome Monitoring Framework (OOMF)
- Data Governance Quality Index (DGQI)
- Monitoring of Global Indices for Reforms and Growth (GIRG)
- Institutionalizing and Promoting Evaluations
- Engagement with States
- Capacity Building

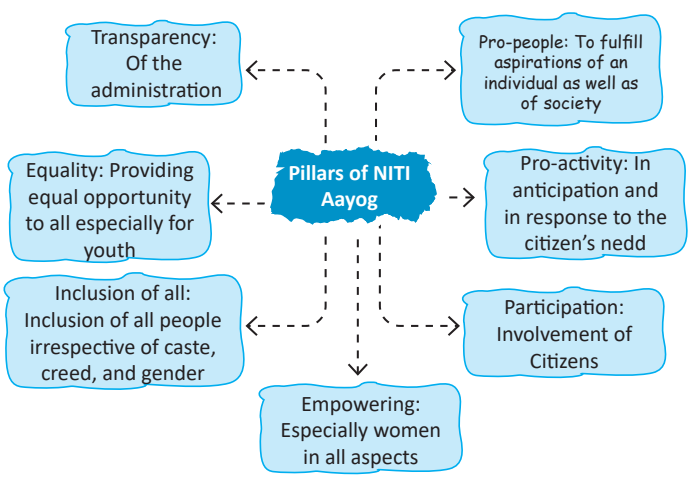

Transparency: Of the administration
Pro-people: To fulfill aspirations of an individual as well as of society
Equality: Providing equal opportunity to all especially for youth
Pillars of NITI Aayog
Pro-activity: In anticipation and in response to the citizen's nedd
Inclusion of all: Inclusion of all people irrespective of caste, creed, and gender
Participation: Involvement of Citizens
Empowering: Especially women in all aspects

Fig. 4.3: Pillars of NITI Aayog

Role

- NITI Aayog is mandated to coordinate the implementation of the **'Transforming our world: the 2030 Agenda for Sustainable Development,'** also known as SDGs.
- Developed as an advancement from the **Millennium Development Goals,** SDGs, consisting of **17 goals and 169 targets,** were established during the UN Summit in September 2015, with India represented at the Hon'ble Prime Minister level. The SDGs aim to drive action over 15 years in critical areas for humanity and the planet.
- NITI Aayog's responsibility goes beyond periodic data collection to proactive action, achieving goals and targets quantitatively while upholding high-quality standards.
- Collaborating with the **Ministry of Statistics and Programme Implementation (MOSPI),** a parallel exercise has been initiated to evolve indicators reflecting SDG goals.
- To accomplish these objectives, an initial step involves the **draft mapping of goals and targets,** which has been conducted in collaboration with MOSPI, consulting proposed Nodal and other Ministries.
- As an illustrative measure, the mapping includes **Centrally Sponsored Schemes (CSSs),** encompassing **'core of the core,' 'core,' and optional schemes** being implemented by the States. This mapping also incorporates recent initiatives by the Central Government.
- Furthermore, both Central Sector Schemes implemented by Ministries and various State Schemes aligned with one or more SDGs are considered in this comprehensive mapping process.

Vision, Strategy and Action

- The 15-year vision document includes a **seven-year strategy** for 2017-24 as the **National Development Agenda.**
- Additionally, a **three-year Action Agenda** from 2017-18 to 2019-20 is being formulated, divided into seven parts with specific action points to boost economic growth.
- The conclusion of the 12th five-year plan on March 31, 2017, marked the initiation of the **three-year action plan** from April 1, discontinuing the previous approach of waiting for state governments to implement schemes.
- NITI Aayog is also entrusted with crafting a **15-year Vision Document and a seven-year strategy** guiding government development initiatives until 2030.

Policies and Programmes of NITI Aayog

NITI Aayog has been assigned the responsibility of formulating strategic and long-term policy and program frameworks, overseeing their progress and effectiveness, with the active engagement of states, civil society, and other think tanks.

As India embarks on the **Amrit Kaal,** the 25-year period leading up to **India@100 in 2022–23,** NITI Aayog is playing a leading role in fostering macro-economic growth and prioritizing all-encompassing welfare at the microeconomic level. **Some of them are as follows.**

Aspirational Districts Programme (ADP)

- The Programme completed five years in January 2023, navigating challenges, including the COVID-19 pandemic. The program has proven to be an exemplary model of effective governance, showcasing remarkable progress in 112 backward districts across critical sectors.
- Its strength lies in **data-driven governance**, utilizing evidence-based policy interventions at the district level.
- NITI Aayog monitors these districts monthly using **Key Performance Indicators (KPIs)** designed to evaluate input and process indicators, aiming for desirable outputs across major socio-economic themes.
  - The robust monitoring strategy fosters cross-departmental reviews, encouraging continuous improvement.
- Districts have shown significant progress in health, nutrition, education, agriculture, water resources, financial inclusion, skill development, and basic infrastructure.
- The program's success results from effective collaboration among stakeholders, and line ministries have developed plans for indicator improvement, with Central Prabhari Officers guiding districts.
- Real-time data collection through **"The Champions of Change"** dashboard and the publication of success stories and best practices further highlight the program's effectiveness.
- NITI Aayog shares these insights regularly, emphasizing the potential for scaling up best practices to address challenges in other parts of the country.
  - **Aspirational Blocks Programme (ABP):** The Aspirational Blocks Programme (ABP), launched by the Hon'ble Prime Minister, accelerates comprehensive development in 500 backward blocks. Selected from 28 states and 4 Union Territories through extensive consultations, the program aims to **expedite the coordinated implementation of various schemes.** Its goal is to **improve block performance,** surpassing state averages and other blocks, with incentives for high achievers based on key indicators.
  - **Mission Utkarsh:** In Mission Utkarsh, Ministries/ Departments with significant public interface have identified the most backward districts based on their respective **Key Performance Indicators (KPIs).** The mission is focused on narrowing the development gap by striving to align these backward districts with state averages within the next year and reaching the national average within the subsequent two years. The initiative aims to **expedite progress and upliftment** in the identified disadvantaged districts.

Asset Monetization

- **National Monetization Pipeline (NMP):** Core Asset Monetisation, a key component of enhanced and sustainable infrastructure financing, was identified as one of the three pillars in the Union Budget 2021–22. NMP, developed by NITI Aayog, outlines the policy framework and lists potential core assets for monetisation, with an indicative value of Rs 6.0 lakh crore over FY22-25. Released in August 2021, the NMP serves as a **roadmap for identifying monetisation-ready projects** in various sectors.

Industry

- **Production-Linked Incentive (PLI) Scheme:** NITI Aayog, in collaboration with associated ministries, introduced the Production Linked Incentive (PLI) Scheme for key sectors **to boost manufacturing and exports** in India. Approved by the Union Cabinet in November 2020, the scheme incentivizes incremental production for eligible anchor entities in selected sectors, promoting investment in technology, plant & machinery, and R&D. Anticipated benefits include the creation of a robust supplier base, **fostering primary and secondary employment** opportunities. The schemes aim to spur production over Rs. 40 Lakh Crore and generate approximately 60 lakhs of additional employment in the next five years across 14 sectors.
- **Committee on Decriminalization:** NITI Aayog, under the leadership of its CEO, established an inter-ministerial committee in March 2022 titled **'Decriminalizing Non-compliance for Ease of Doing Business in India.'** The data and insights gathered from reviews of 36 ministries have been conveyed to DPIIT for subsequent actions and standardization across ministries. NITI Aayog remains engaged in supporting DPIIT in the decriminalization efforts to enhance the ease of doing business.
- **Taskforce on Enforcement of Contract:** Under the leadership of the Vice Chairman of NITI Aayog, a task force was established to examine the implementation of the **Commercial Courts Act, 2015.** Meetings with Supreme Court and Delhi High Court representatives, along with Commercial Courts, were conducted to pinpoint procedural, human resource, and infrastructure gaps. Additionally, an online survey was undertaken across all Commercial Courts and High Courts to identify bottlenecks related to infrastructure and human resources.

IGNITE YOUR MIND

Is reinstating a reformed version of The Planning Commission a beneficial move for India, considering the criticism that Niti Aayog acts more as a government favoring recommendatory body rather than a robust planning authority?

Competitive Federalism

NITI Aayog strives to foster competitive federalism by enhancing the performance of States/UTs. It **promotes healthy competition** among states by transparently ranking them across various sectors and providing supportive guidance.

- **Export Preparedness Index:** The Export Preparedness Index (EPI) has been developed by NITI Aayog in partnership with the Institute for Competitiveness in order to rank all States and UTs on the basis of their export readiness and performance. The EPI is based on four pillars—
  - Export Policy,
  - Business Environment,
  - Export Infrastructure, and
  - Export Performance.
- **Multidimensional Poverty Index:** The national MPI project aims to customize the global MPI for India, aligning it with the country's priorities in health, education, and standard of living. It assesses deprivation across **12 indicators, with two additional indicators** focusing on maternal health and financial inclusion. The goal is to develop reform action plans to enhance India's standing in global MPI rankings.
- **Sustainable Development Goal India Index:** The SDGs India Index comprehensively documents and ranks the progress of States and UTs in achieving Sustainable Development Goals, identifying crucial gaps and informing interventions for accelerated progress at national and sub-national levels. It serves as a valuable tool for assessing advancements in various Global Goals, including health, education, gender, economic growth, institutions, climate change, and the environment.

Document by NITI Aayog

- Fifteen-Year Vision,
- Seven Year Strategy, and
- Three-Year Action Agenda.

The NITI Aayog is currently in the process of preparing documents outlining the Fifteen-Year Vision and Seven-Year Strategy.

Three-Year Action Agenda

- **Reduce the fiscal deficit** from 4.5 percent to 3 percent by 2018-19 and decrease the revenue deficit from 3.2 percent to 0.9 percent by 2019-20.
- Its aimed at **doubling farmers' income** by 2022 and focuses on **job creation** in the trade, industry, and service sectors.
- Implement **urban and rural development strategies,** emphasizing regional approaches for areas like the northeast, coastal regions, islands, North Himalayan states, and desert and drought-prone states.
- Strengthen **transport infrastructure,** encourage public-private partnerships in the infrastructure sector, and ensure **last-mile digital connectivity.**
- Target **electricity for all households** and LPG connections for every household by 2022, **eliminate black carbon** by 2022, and extend the city gas distribution program to 100 Smart Cities.
- Establish a **National Science & Technology and Innovation Foundation** to address national issues.
- Develop a roadmap for closing select loss-making Public Sector Enterprises (PSEs) and **strategically disinvest** in 20 identified Central Public Sector Enterprises (CPSEs).
- Address tax evasion, expand the tax base, and **simplify the tax system** through reforms.
- Implement **judicial system reforms**, introduce education sector reforms, including the creation of world-class universities, and undertake health sector reforms such as amending acts and launching the National Nutrition Mission.
- Enhance the **welfare** of women, children, youth, minorities, reserved classes, differently-abled persons, and senior citizens.
- Implement **environment-related measures** to tackle city air pollution and adopt sustainable practices, including the sustainable use of water resources.

Performance Analysis of NITI Aayog

Sector	Programme, Policy and Scheme
Contributions to Major Agricultural Sector Reforms	❑ **Implementation of Minimum Support Price (MSP) for notified crops:** Following NITI Aayog's advice, the Ministry of Agriculture and Farmers' Welfare launched the **Pradhan Mantri Annadata Aay Sanrakshan Abhiyan (PM-AASHA)** in 2018, including three mechanisms: • **Price Support Scheme (PSS)** or Market Assurance Scheme • **Price Deficiency Payment Scheme** • Pilot on **Private Procurement Stockists Scheme.** ❑ **Model Act on Contract Farming:** Formulated by the Ministry in consultation with NITI Aayog to empower farmers to decide the price of their produce and negotiate with buyers. ❑ **Business Model for Doubling of Farmers' Income:** NITI Aayog set up a task force to encourage the application of science and technology in agriculture production, minimize farmers' risks, and incorporate modern business practices. ❑ **Agriculture Export Policy:** NITI Aayog provided inputs to the Ministry of Commerce and Industries, emphasizing the need for the Agricultural Export Policy to address the global export environment and emerging demand.

Sector	Programme, Policy and Scheme
	❑ **Gramin Agricultural Markets (GrAM):** Introduced in the 2018-19 Budget with the intention to develop and **upgrade existing 22,000 rural haats** into Gramin Agricultural Markets (GrAMs). ❑ **Model Agriculture Land Leasing Act, 2016:** Formulated by NITI Aayog to recognize the rights of tenants and safeguard the interests of landowners, along with a dedicated cell for land reforms. ❑ **Agriculture Marketing and Farmer-Friendly Reforms Index:** Introduced to assess the need for reforms in three key areas: **Market Reforms, Land Lease Reforms, and Forestry on Private Land** (Felling and Transit of Trees)
Contributions to Major Nutritional Sector Reforms:	❑ **National Nutrition Strategy:** Formulated by NITI Aayog, shaping and launching the **National Nutrition Mission or POSHAN Abhiyaan** by the Ministry of Women and Child Development (MoWCD). NITI Aayog is responsible for monitoring and periodically evaluating the mission. ❑ **National Council on India's Nutritional Challenges:** Constituted by MoWCD, chaired by the Vice-Chairman of NITI Aayog, to provide policy directions and coordinate efforts to address India's nutritional challenges. ❑ **National Technical Board of Nutrition (NTBN):** Constituted by MoWCD, chaired by a member of NITI Aayog, to provide technical, responsive, and evidence-based recommendations on nutrition-related policy issues concerning women and children.
Contributions to Major Health Sector Reforms:	❑ **Ayushman Bharat Scheme:** NITI Aayog significantly contributed to the conceptualization and design of the Ayushman Bharat Scheme in close coordination with the Ministry of Health and Family Welfare (MoH&FW). ❑ **National Medical Commission Bill:** NITI Aayog played a role in the formulation of the National Medical Commission Bill, proposing to replace the Medical Council of India with the new National Medical Commission. ❑ **National Commission for Homoeopathy (NCH) Bill, 2018, National Commission for Indian System of Medicine Bill, 2018, and National Commission for Yoga and Naturopathy Bill, 2018:** NITI Aayog contributed to the formulation of these bills.
Contributions to Major Educational Sector Reforms	❑ **Performance-Based Graded Autonomy Framework:** NITI Aayog contributed to the formulation of a framework for providing greater autonomy to universities. ❑ **Strengthening the Accreditation Framework:** NITI Aayog contributed to the strengthening of the accreditation framework, enabling additional agencies, including third-party agencies, to accredit higher education institutions.
Contributions to Major Mineral Sector Reforms	❑ **Draft National Mineral Policy 2018:** NITI Aayog played an active role in framing the draft National Mineral Policy 2018 by constituting two committees on the utilization of fly ash and slag. ❑ **Strategy for Self-Reliance in Rare Earth Minerals:** NITI Aayog constituted various committees to develop a strategy for self-reliance in rare earth minerals and a roadmap to combat restrictive trade practices.
Contributions to Energy Sector Reforms	❑ Drafting of National Energy Policy 2018: NITI Aayog initiated the drafting of the National Energy Policy 2018 to address objectives such as increased energy accessibility, enhanced energy independence, greater sustainability, and higher economic growth.
Transforming India's Gold Market	❑ A Committee on Transforming India's Gold Market was constituted by NITI Aayog to recommend measures for tapping into the potential of the gold market in India and providing a stimulus to exports, economic growth, and employment.
Atal Innovation Mission (AIM)	❑ AIM was launched under NITI Aayog to foster an innovative temperament in the country's entrepreneurship ecosystem. **Atal Tinkering Labs (ATLs)** are established in schools to encourage creativity and scientific temperament among students.
Building an Inclusive and Sustainable India	❑ NITI Aayog has undertaken various measures and initiatives toward building an inclusive and sustainable India, with recent initiatives falling under categories such as **Ek Bharat Shrestha Bharat, Sustainable Action for Transforming Human Capital (SATH), Development Support Services to States (DSSS),** and assistance in the preparation of State Human Development Reports.

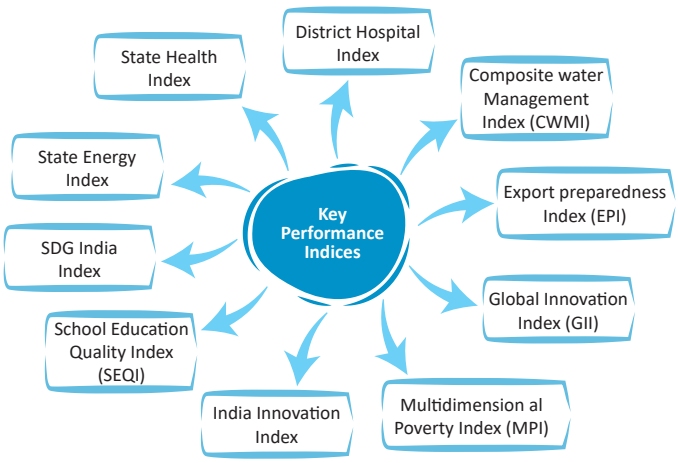


Fig. 4.4: NITI Aayog Key Performance Indicator

Difference Between NITI Aayog and Planning Commission

NITI Aayog	Planning Commission
❑ No power to allocate funds to Ministries and states.	❑ Powers to allocate funds to Ministries and states
❑ It comprises all the Chief Ministers of states and administrators of UT in its governing council.	❑ The Role of State was restricted as they needed to interact yearly with the Planning Commission to get their annual plan approved.
❑ Adopted a bottom-up approach in planning.	❑ Adopted top-down decision making.

Critical Appraisal of NITI Aayog

Positive Aspects

- **Policy Formulation and Coordination:**
  - NITI Aayog serves as a 'Think-Tank' and a coordinating body for formulating economic policies and development strategies.
  - It provides a platform for states and union territories to actively participate in the economic planning process.
- **Flexibility and Innovation:**
  - NITI Aayog replaced the Planning Commission with a more flexible and adaptive approach to economic planning.
  - The institution is designed to promote innovation, entrepreneurship, and cooperative federalism.
- **Focus on Sustainable Development:**
  - NITI Aayog has emphasized sustainable development goals and introduced indices to monitor and rank states' performance in various sectors.
- **Public-Private Partnership (PPP)**
  - The institution encourages public-private partnerships and seeks to involve the private sector in the development process.

Areas of Concern

- **Limited Financial Powers:**
  - Unlike the Planning Commission, NITI Aayog lacks financial powers. It does not have control over financial resources for plan implementation.
  - The absence of financial control may limit its ability to enforce its recommendations.
- **Criticism of Performance Indices:**
  - Some states have criticized the methodology of performance indices, arguing that they do not accurately reflect the ground reality.
  - The indices' reliance on certain parameters may not capture the diverse development challenges faced by different states.
- **Need for More Statutory Powers:**
  - NITI Aayog operates as an advisory body without statutory powers. There are calls for giving it more statutory authority to enhance its impact.
- **Resource Mobilization and Implementation:**
  - The institution faces challenges in mobilizing resources for the proposed schemes and ensuring effective implementation on the ground.
  - Achieving consensus among states with diverse priorities can be a complex task.
- **Critique of Vision and Planning:**
  - There have been criticisms that NITI Aayog's vision and planning lack specificity and clear roadmaps for achieving economic goals.

Thus, while NITI Aayog has brought about a shift in the approach to economic planning, it faces challenges in terms of financial autonomy, methodology in performance measurement, and the need for more statutory powers. Its effectiveness will depend on its ability to address these challenges and adapt to changing economic landscapes.

Road to 5 Trillion $ Economy

- The government's plan to elevate India to a $5 trillion economy involves emphasizing macro-level growth while concurrently ensuring comprehensive welfare measures at the micro level.
- It centers around promoting a digital economy, embracing fintech, fostering technology-driven development, steering the transition to sustainable energy, championing climate action, and leveraging a virtuous cycle of investment and growth. This strategic roadmap was initiated in 2014.
- Achieving a $5 trillion economy presents both opportunities and challenges for a country.

Opportunities

- **Demographic Dividend:** India has a large, youthful population, which can contribute significantly to the workforce and economic productivity.

- India is one of the **youngest countries in the world,** with 27.3% of its population aged 15–29 years, (Report of Technical Group on Population Projections for India and States 2011-2036, Ministry of Health & Family Welfare).

- **Digital Transformation:** The rapid adoption of digital technologies can boost efficiency, innovation, and financial inclusion.
- **Entrepreneurship and Start-ups:** A thriving entrepreneurial ecosystem can drive innovation, generate employment, and contribute to economic growth.
- **Global Trade:** Leveraging international markets for exports and investments can be a key driver of economic expansion.
- **Infrastructure Development:** Investments in infrastructure, such as transportation and energy, can enhance overall productivity and competitiveness.

Challenges

- **Income Disparities:** Addressing income inequalities and ensuring inclusive growth is a significant challenge.
  - According to the **'World Inequality Report 2022,'** India stands among the most unequal nations globally, marked by increasing poverty and the presence of an **'affluent elite.'**
- **Job Creation:** Creating enough jobs to absorb the growing workforce is crucial for sustained economic growth.
- **Financial Sector Reforms:** Strengthening and reforming the financial sector to support large-scale investments is imperative.
- **Bureaucratic Hurdles:** Reducing bureaucratic red tape and improving the ease of doing business is essential.
- **Environmental Sustainability:** Balancing economic growth with environmental sustainability is a critical challenge.

Actions to be Taken

- **Policy Reforms:** Implementing and sustaining key economic reforms, including tax policies, regulatory frameworks, and labor laws.
- **Investment in Education and Skills:** Focusing on education and skill development to enhance the employability of the workforce.
- **Digital Infrastructure:** Expanding and improving digital infrastructure to facilitate digital transactions and e-commerce.
- **SME Support:** Providing support to **small and medium enterprises (SMEs)** to spur entrepreneurship and job creation.
- **Sustainable Development:** Integrating sustainable development practices to ensure long-term environmental and economic health.

Effectively tackling these challenges and seizing opportunities demands a **united effort** from the government, private sector, and civil society. Regular **monitoring and adaptive policy measures,** responsive to evolving global and domestic conditions, are crucial for the successful achievement of a $5 trillion economy.

Steps Taken For Achieving a $5 Trillion Economy

- **Reforms Undertaken:**
  - **Goods and Services Tax (GST):** The introduction of GST aimed at simplifying the tax structure and promoting a unified tax system.
  - **Insolvency and Bankruptcy Code (IBC):** The implementation of IBC facilitated the efficient resolution of insolvency cases, enhancing the business environment.
  - **Corporate Tax Rate Reduction:** A substantial reduction in the corporate tax rate was undertaken to stimulate investment and economic growth.
  - **Make in India and Start-up India:** Strategies like Make in India and Start-up India were introduced to encourage manufacturing and foster entrepreneurship.
  - **Production Linked Incentive Schemes:** Initiatives like Production Linked Incentive Schemes were rolled out to incentivize production in key sectors.
- **Capital Investment Increase for Economic Growth:**
  - **Capex-Led Growth:** The government adopted a capex-led growth strategy, focusing on increasing capital investment to spur economic growth and attract private sector investment.
  - **Government's Capital Expenditure:** The central government's capital expenditure rose from 2.15% of GDP in 2020-21 to 2.7% in 2022-23.
- **Steps in Union Budget 2023-24:**
  - **Capital Investment Outlay:** The Union Budget for 2023-24 emphasizes sustaining India's economic growth by significantly increasing the capital investment outlay for the third consecutive year, reaching ₹10 lakh crore (3.3% of GDP).
  - **Direct Capital Investment:** The Central Government's direct capital investment is complemented by Grants-in-Aid to States, supporting the creation of capital assets.

CONCLUSION

India's economic compass spins toward inclusive, sustainable growth, guided by strategic reforms like GST and Make in India. Budget 2023's capex surge fuels a business-friendly engine, propelling India toward a $5 trillion goal. Resilience, innovation, and widespread well-being blossom on this multi-pronged roadmap, as India transforms into a dynamic economic powerhouse, balancing macro aspirations with micro realities.

Inclusive Growth

5

INTRODUCTION

> Inclusive growth is economic growth that is distributed fairly across society and creates opportunities for all.
>
> —**OECD**

According to the definition given by **UNDP**, Inclusive Growth can be defined as **"the process and result of all groups of people participating in the organisation of growth and benefiting equitably from it."**

Inclusive growth goes beyond simply growing the economy. It's about creating a dynamic system that generates opportunities for all, reduces poverty, and enhances well-being for everyone, regardless of their background. It's about ensuring access to essential services like healthcare and education, and empowering individuals through education and skill development.

Inclusive growth also recognizes the importance of environmental sustainability and good governance. It seeks to promote responsible economic development that protects our planet and fosters a society built on transparency, accountability, and participation.

Inclusive growth is not simply about expanding the economy; it's about creating a society where everyone has the opportunity to thrive and contribute to their full potential. This requires a multi-dimensional approach focused on **four key attributes:**

- **Opportunity:** Generating and expanding opportunities for people to earn a living and improve their income levels. This includes creating jobs, promoting entrepreneurship, and fostering economic development in underserved areas.
- **Capability:** Providing individuals with the means and skills they need to capitalise on available opportunities. This involves investing in education, training, healthcare, and other programs that enhance human capital and empower individuals to participate meaningfully in the economy.
- **Access:** Ensuring that people have the resources and connections necessary to connect with opportunities and utilise their capabilities. This includes addressing issues of discrimination, social exclusion, and lack of infrastructure that may hinder access to essential services and economic participation.
- **Security:** Providing individuals with a safety net to protect them against unexpected shocks and vulnerabilities that can lead to poverty and hardship. This includes social safety programs, access to credit, and disaster preparedness measures.

These four attributes work together to create an environment where inclusive growth is possible. By focusing on opportunities, capabilities, access, and security, we can ensure that everyone has a chance to participate in economic growth and benefit from its fruits.

The relationship between inclusive growth and poverty reduction is clear. Rapid and sustained economic growth is necessary for significant reductions in poverty. However, for this growth to be sustainable and impactful, it must be inclusive, allowing all segments of society to contribute and reap the benefits.

FEATURES OF INCLUSIVE GROWTH

- **Long-Term, Sustainable Growth:** Inclusive growth prioritises sustained economic expansion that benefits all members of society over the long term. This requires a broad-based approach that promotes diversification across sectors and ensures opportunities for a wider segment of the workforce.
- **Equality of Opportunity:** Inclusive growth emphasises creating a level playing field where everyone has equal access to markets, resources, and a fair regulatory environment. This fosters equal opportunities for participation in economic activities and helps reduce inequality.
- **Pace and Pattern of Growth:** The pace and pattern of economic growth play a crucial role in poverty reduction. Inclusive growth strategies must consider country-specific circumstances and focus on generating growth in a way that empowers the poor and creates productive employment.
- **Focus on Productive Employment:** While income redistribution can play a role, inclusive growth emphasises creating productive jobs with decent wages and working conditions. This increases individual income and overall economic productivity, leading to sustainable poverty reduction.
- **Individual as the Subject:** Inclusive growth recognizes the individual as a key agent in the development process. It focuses on empowering individuals through education, skills training, and access to resources, allowing them to participate effectively in the economy.

- **Absolute Poverty Reduction:** Under the absolute definition, growth is considered to be pro poor as long as poor people benefit in absolute terms as reflected in some agreed measures of poverty. In contrast, in the relative definition, growth is pro poor if and only if the income of poor people grow faster than those of the population as a whole, i.e., inequality declines. where the focus is on improving the lives of the poor in absolute terms, irrespective of relative changes in income distribution.
- **Outcome-Driven, Not Target-Specific:** Inclusive growth is not defined by specific targets like employment generation or income distribution. These are potential outcomes, not predetermined goals. This allows for flexibility in designing policies and strategies tailored to specific contexts.
- **Market-Driven Growth with Government Facilitation:** Inclusive growth is typically driven by market forces, with the government playing a crucial role in facilitating a conducive environment for business and individual participation. This includes promoting fair competition, providing essential infrastructure, and investing in human capital development.

Elements of Inclusive Growth

Inclusive growth aims to ensure that all sections of society benefit from economic progress, not just a privileged few. Achieving this requires focusing on several key elements:

Skill Development

- **Challenges: India faces a dual challenge:**
  - **Paucity of highly trained workforce:** Skill gaps hinder the employability of a significant portion of the population.
  - **Non-employment of conventionally trained youth:** Many graduates remain unemployed, indicating a mismatch between skills and market demands.
- **Solutions:**
  - **Investing in Skill Development Programs:** Equipping the workforce with relevant skills is crucial for boosting employability and productivity.
  - Addressing the needs of **NEET youth** means number of young people not in education, employment, or training. Providing targeted programs to integrate them into the workforce through education, training, and employment opportunities.

Financial Inclusion

- **Why it matters:** Providing access to financial services empowers individuals and communities to participate in the formal economy.
- **Benefits:**
  - **Promotes savings:** Enables individuals to build financial security and invest in their future.
  - **Facilitates investment:** Encourages entrepreneurship and small business development.
  - **Reduces inequality:** Empowers vulnerable groups and increases their access to economic opportunities.

Technological Advancement

- **The Digital Revolution:** The world is experiencing the Industrial Revolution 4.0, driven by technological advancements.
- **Potential for good and bad:** Technology can either exacerbate inequality or promote inclusive growth, depending on its implementation.
- **Government initiatives:** Programs like Digital India Mission aim to equip the population with digital literacy to leverage technology for economic and social development.

Economic Growth

- **Current scenario:** India is a fast-growing economy, but facing challenges like slowdowns due to cyclic and structural factors.
- **Aspirational target:** Achieving the $5 trillion economy goal by 2024-25 can create significant benefits:
  - **Reduced inequality:** Increased economic opportunities can lead to more equitable distribution of resources.
  - **Increased social expenditure:** Higher GDP allows for greater investment in essential services like education and healthcare.
  - **Employment creation:** A strong economy generates more jobs, reducing unemployment and poverty.

Social Development

- **Empowering marginalised communities:** Inclusive growth requires focusing on the needs of disadvantaged groups like SC/ST/OBCs, minorities, women, and transgenders.
- **Investing in social infrastructure:** Building strong institutions like hospitals, schools, and universities improves access to essential services and promotes social mobility.
- **Benefits of social investment:**
  - **Boosts economic growth:** Investment in social infrastructure can act as a fiscal stimulus.
  - **Creates a skilled workforce:** Educated and healthy individuals contribute to a more productive and competitive economy.
  - **Promotes social cohesion:** Inclusive social development fosters a more equitable and stable society.

These elements of inclusive growth are interconnected and mutually reinforcing. By focusing on skill development, financial inclusion, technological advancement, economic growth, and social development, India can create a more just and prosperous society for all its citizens.

NEED FOR INCLUSIVE GROWTH

India's economic rise is undeniable, boasting a GDP of over $3 trillion and the fastest-growing major economy tag. Yet, a troubling reality lies beneath the glitter – extensive inequalities and exclusions that render this growth unsustainable and unfair.

In policy circles, the term "inclusive growth" has gained prominence due to the recent trend of rapid growth accompanied by exclusionary patterns. The government aimed to foster inclusive growth, recognizing that high national income growth alone couldn't address challenges like employment promotion, poverty reduction, balanced regional development, and improved human development.

- **Bridging the Inequality Gap:** The richest 1% hold over 40% of national wealth, while the bottom 50% own a mere 3%. This translates to 22% of the population (300 million people) living below the national poverty line.
- **Empowering Disadvantaged Groups:** Rural inhabitants, women, and marginalized communities face systemic barriers, with over 65% residing in rural areas lacking access to infrastructure and opportunities.
- **Tackling Human Development Deficits:** Inadequate public spending on healthcare leaves millions vulnerable, while poor quality education and malnutrition among children hamper potential.
- **Unlocking Sustainable Growth:** Environmental degradation and climate change pose long-term risks. Balancing economic growth with environmental protection and social well-being is crucial.

Challenges of Inclusive Growth

India's progress in poverty reduction has been remarkable, lifting millions from poverty in recent years. However, significant challenges remain in achieving truly inclusive growth.

Persistent Poverty

- Despite progress, millions remain trapped in multidimensional poverty, lacking basic necessities and facing acute deprivations.
- 30% of the population lives below the poverty line due to limited education, skills, and access to formal employment.

Unemployment and Underemployment

- High unemployment rates, especially among the youth, threaten to undermine inclusive growth.
- Skills mismatch, low-quality jobs, and limited access to social security exacerbate the problem.
- 93% of the workforce toils in the informal sector, characterized by low wages, minimal productivity, and lack of social security.

Agriculture Backwardness

- While agriculture employs a significant portion of the population (43%), its contribution to GDP remains low (16%).
- Issues like land availability, declining productivity, and limited access to resources hinder growth in the sector.
- Disguised unemployment, fragmented landholdings, and dependence on monsoons hinder progress.

Regional Disparities

- Wide gaps exist in development indicators across different regions of India.
- This disparity creates an uneven playing field and perpetuates inequalities.

Social Development Challenges

- Low public spending on health and education, along with poor delivery systems, hinder progress in social development.
- This disproportionately impacts marginalised communities and vulnerable groups.
- Unmet aspirations and exclusion can fuel social unrest, threatening stability and harnessing the potential of the "demographic dividend."

Dismissing these aspirations is not an option, and if India fails to address them, the much-touted **"demographic dividend"** could turn into a demographic nightmare. Inclusive growth is crucial, necessitating pragmatic policies to address inequalities generated by growth. Balancing economic growth with human development and sustainability remains a challenge for planners and policymakers.

GOVERNMENT SCHEMES FOR INCLUSIVE GROWTH

Inclusive growth aims to ensure that everyone benefits from economic prosperity. To achieve this, governments implement various schemes that address different aspects of inequality and lack of opportunity.

Some of Those Key Initiatives in India

Digital Empowerment

- **Digital India:**
  - Weaving a digital future for all, this program champions affordable internet access through initiatives like BharatNet and Pradhan Mantri Gram Swarojgar Yojana (PMGSY), connecting rural communities and bridging the digital divide.
  - Its focus on digital literacy training, through schemes like "Pragyata," empowers citizens to navigate the online world confidently.
  - E-governance platforms like e-Aarogya and e-NAM streamline government services, fostering transparency and efficiency.
- **e-Kranti Bharat:**
  - Transforming citizen interactions, e-Kranti Bharat digitises government services, from filing taxes to obtaining land records.

- This not only improves efficiency and reduces corruption but also empowers citizens with easier access to essential services.

Financial Inclusion

- **Life Insurance:**
  - Pradhan mantri Jeevan Jyoti Bima yojana offers life insurance for as low as Rs.436 per year, providing much-needed financial security for millions of low-income families.
  - PMSBY provides affordable accidental death coverage, giving families peace of mind.
- **Pensions and Banking:**
  - Atal pension yojana offers guaranteed monthly pensions to workers in the unorganised sector, ensuring financial stability after retirement. PMJDY, with over 500 million accounts opened, has revolutionised access to banking services, including micro-credit and insurance, for financially excluded communities.

Rural Development

- **MGNREGA:**
  - Guaranteeing 100 days of work per year for rural households, MGNREGA has not only boosted rural income but also created valuable infrastructure assets like roads and irrigation canals.
- **Kisan Card and PM Kisan Samman Nidhi:**
  - Empowering small and marginal farmers, Kisan Card provides subsidised access to fertilisers and seeds, while PM Kisan Samman Nidhi offers income support of ₹6,000 per year, improving farm productivity and financial security.

Entrepreneurship and Skill Development

- **Supporting Entrepreneurs in Transformation and Upskilling (SETU)**:
  - The initiative would connect start-ups in India to US-based investors and start-up ecosystem leaders with mentorship and assistance in various areas including funding, market access and commercialization.
  - Bridging the gap between aspirations and opportunities, SETU equips individuals with relevant skills and financial assistance to launch their own businesses, fostering self-reliance and generating employment.
- **National Skill Development Mission:**
  - Recognizing the critical role of skilled workforce in economic growth, NSDM imparts industry-aligned skills through partnerships with leading companies and vocational training institutes, enhancing employability for youth.

Social Development

- **Sarva Shiksha Abhiyan:**
  - Committed to universal elementary education, SSA has built and upgraded schools, provided free textbooks and uniforms, and empowered millions of children, particularly girls, with access to quality education.
- **National Rural Health Mission:**
  - Strengthening healthcare infrastructure in rural areas, NRHM has established primary health centres, trained community health workers
  - Increased access to affordable healthcare services, improving health outcomes for rural communities.
- **DISHA Project**:
  - Standing as a testament to collaboration, DISHA empowers women through entrepreneurship and employment opportunities.
  - This joint initiative between the Indian government and UNDP leverages expertise and resources to provide skill training, micro-loans, and market linkages, enabling women to become economic agents of change in their communities.

Measuring Inclusive Growth

Ensuring inclusive growth requires reliable measurements that capture not just economic progress, but also social and environmental factors.

Here's an overview of some key indices:

1. Inclusive Development Index (IDI)

- **Developed by the World Economic Forum,** IDI assesses inclusivity based on three pillars:
  - **Growth and development:** Economic performance and infrastructure.
  - **Inclusion:** Education, healthcare, and social security.
  - **Intergenerational equity and sustainability:** Environmental protection and resource management.
- **In the 2023 IDI, India ranked 62nd out of 74 emerging countries,** highlighting room for improvement in inclusivity.
- India's best performance was in "intergenerational equity and sustainability", likely due to its youthful population.

2. Social Progress Index (SPI)

- **Developed by the Social Progress Imperative,** SPI measures the well-being of citizens across three dimensions:
  - **Basic human needs:** Nutrition, water, sanitation, shelter, and personal safety.
  - **Foundations of well-being:** Access to knowledge, information, and communication.
  - **Opportunity:** Personal rights, freedom of choice, and access to advanced education.
- SPI offers a more comprehensive picture than GDP, as it incorporates social and environmental factors.
- While not yet available for India, SPI provides a valuable framework for assessing inclusivity.

Limitations of Other Indices

- **GDP:** Ignores non-market activities and environmental impact.
- **Gini Coefficient:** Only measures income inequality.
- **Gross Happiness Index:** Ignores gender neutrality and educational attainment.
- **Human Development Index (HDI):** Does not consider the distribution of wealth.

Benefits of SPI

- **Outcome-oriented:** Measures the tangible outcomes of government policies and interventions, rather than simply focusing on financial expenditure.
- **Efficiency assessment:** Analyses how effectively government resources are utilised to achieve positive social outcomes.
- **Comprehensive approach:** Considers a wider range of factors beyond just economic indicators, providing a more holistic view of societal progress.

3. Global Slavery Index (GSI)

- **Developed by the Walk Free Foundation,** GSI estimates the prevalence of modern slavery across countries.
- Modern slavery includes forced labour, human trafficking, and debt bondage.
- GSI highlights the need for governments to address the root causes of modern slavery, such as poverty, inequality, and lack of access to education and healthcare.
- India has made strides in criminalising slavery-related practices, but continued efforts are needed to eradicate it completely.

The **World Economic Forum (WEF)** has outlined three concrete steps for countries to achieve both social inclusion and economic growth:

Investing in Capabilities:

- **Focus:** Increasing public and private investments in citizens' skills and knowledge.
- **Benefit:** This is the most effective way to achieve sustainable high productivity growth, leading to better living standards for all.
- **Examples:** Investing in education, healthcare, training programs, and other initiatives that equip individuals with the tools they need to succeed.

Upgrading Labor Market Rules and Institutions

- **Focus:** Governments, in collaboration with employers and workers, should address outdated labour market regulations and institutions.
- **Benefit:** This improves the quantity and quality of jobs, promotes fair compensation, and boosts purchasing power, leading to increased aggregate demand within the economy.
- **Examples:** Modernising labour laws, facilitating flexible work arrangements, promoting equal pay for equal work, and strengthening worker's rights.

Prioritising Labor-Intensive Sectors:

- **Focus:** Increasing public and private investments in economic sectors that require significant workforce participation and generate broader societal benefits.
- **Benefit:** This promotes job creation, expands economic opportunities for marginalised groups, and supports essential infrastructure development.
- **Examples:** Investing in renewable energy, water management, digital infrastructure, public transport systems, caregiving services, rural economic development, and education and training programs.

Way Forward

- **Unlocking the Untapped Potential:** The growing importance of the unorganized non-farm sector as a driver of growth.

IGNITE YOUR MIND

Since India is also a welfare state, inclusive growth is a key determinant of development, as also mandated by the constitution. Can you think of constitutional articles/provisions which talk about inclusive growth?

- **Building Bridges, Not Walls:** The need for infrastructure and market linkage with rural areas to unlock this sector's potential.
- **Empowering Innovation:** The role of skills, technology, and credit in empowering individuals and fostering innovation.
- **Unleashing the Entrepreneurial Spirit:** The potential of entrepreneurship and a competitive environment to boost economic activity.
- **A Rising Tide Lifts All Boats:** The cyclical nature of inclusive growth, where everyone benefits from increased participation and prosperity.

Tackling this monumental challenge requires collaboration beyond the government; industry and civil society must join forces to propel inclusive growth. This concerted effort holds the key to improving the lives of millions across India. Inclusive growth is not merely an economic aspiration; it is a moral imperative for a nation with India's vast potential.

To quote **Prof. C.K. Prahalad, "If we view the poor not as victims but as resilient and creative entrepreneurs and value-conscious consumers, a world of opportunity will unfold."**

FINANCIAL INCLUSION

Financial inclusion involves providing accessible financial services, such as savings and transactional bank accounts, affordable credit for various purposes, financial advisory

services, remittance, pension, and insurance facilities, to disadvantaged and low-income groups. By making these services available at affordable costs, financial inclusion aims to broaden the resource base of the financial system. It fosters a savings culture among substantial segments of the rural population and contributes to the economic development process.

India's Journey Towards Financial Inclusion

- India's journey towards financial inclusion **began in 1956 with the nationalisation of life insurance companies.**
- Subsequent nationalisations of banks and insurance further strengthened the foundation for financial inclusion.
- The **establishment of Regional Rural Banks in 1975** aimed to bring rural areas into the economic mainstream.
- In **2014, the Pradhan Mantri Jan Dhan Yojana (PMJDY)** was launched to eradicate financial exclusion and provide access to bank accounts for all individuals.
- As of August 2023, PMJDY has successfully opened over 50 crore accounts, reaching millions of previously unbanked individuals.
- Building on these achievements, the RBI's National Strategy for Financial Inclusion (NSFI) 2019-2024 outlines a comprehensive vision for expanding and sustaining financial inclusion in India.

Significance of Financial Inclusion

- Enhancing Awareness and Adoption**:**
  - Increasing awareness about the benefits and ease of using digital financial services is crucial for driving adoption across all segments of the population.
  - This requires targeted campaigns, educational initiatives, and community outreach programs.
- Expanding Acceptance Infrastructure**:**
  - Widespread availability of payment acceptance points, including Point-of-Sale (POS) terminals and QR codes, is essential for enabling seamless digital transactions.
  - Building this infrastructure requires collaboration between financial institutions, merchants, and technology providers.
- Ensuring Security and Privacy**:**
  - Protecting user data and ensuring the security of digital transactions are paramount.
  - This necessitates robust cybersecurity measures, data encryption, and adherence to data privacy principles.
  - Building trust and confidence in the system is crucial for encouraging widespread adoption.
- Monitoring and Evaluation**:**
  - Developing sector-specific action plans with clear targets and mechanisms for monitoring progress is essential.
  - Regular evaluation allows for course correction and ensures the strategy remains effective.
- Strengthening Regulatory Frameworks**:**
  - A strong regulatory and legal framework is vital for protecting consumers' interests, promoting fair practices, and preventing market manipulation.
  - This framework should be constantly adapted to keep pace with the evolving digital landscape.
- Tailored Financial Inclusion Policies**:**
  - Implementing financial inclusion policies tailored to specific sectors, such as small and medium-sized businesses, agriculture, or specific regions, can address their unique needs and challenges.
  - This ensures that no segment is left behind in the journey towards inclusive growth.
- Operationalization of Public Credit Registry**:**
  - The full operationalization of the Public Credit Registry (PCR) by March 2022 will allow authorised financial entities to assess creditworthiness accurately, paving the way for more informed lending decisions and wider access to credit.
  - This can significantly boost financial inclusion and promote economic activity.

Benefits of Financial Iniclusion

- **Job creation:** By providing access to capital, financial inclusion can stimulate entrepreneurship and small business growth, leading to job creation.
- **Reduced vulnerability:** Access to financial services can help individuals and communities cope with economic shocks, such as natural disasters or illness, leading to greater financial security.
- **Increased human capital investment:** Financial inclusion facilitates investments in education, healthcare, and other vital areas, contributing to a more skilled and productive workforce.
- **Multiplier effect:** Studies demonstrate that financial inclusion has a ripple effect, boosting overall economic output, reducing poverty, and narrowing income inequality at the national level.
- **Sustainable development:** Seven of the UN's Sustainable Development Goals (SDGs) highlight financial inclusion as a key enabler for achieving sustainable development globally by improving the quality of life for marginalised communities.

Stakeholders in Financial Inclusion

- **Financial Consumers:** The primary beneficiaries of financial inclusion, requiring access to affordable and convenient financial services.
- **Financial Institutions:** Banks, Non-banking financial companies (NBFCs), microfinance institutions, etc.,provide financial services and products to individuals and businesses.

- **Educational Institutions:** Play a vital role in promoting financial literacy and educating individuals about managing their finances effectively.
- **Non-Governmental Organisations (NGOs):** Work directly with communities, providing financial education, access to financial products, and advocating for policy changes that promote financial inclusion.
- **Regulators in the Financial Sector:** Responsible for creating a stable and enabling regulatory environment that fosters innovation and protects consumers.
- **Central and State Governments:** Provide leadership and direction for national financial inclusion strategies,formulating policies, and allocating resources.
- **International Players:** Organisations like the OECD, G-20, and international development agencies provide valuable technical assistance, knowledge sharing, and financial resources to support financial inclusion efforts in developing countries.

National Strategy For Financial Inclusion (2019-24)

The **Reserve Bank of India (RBI) has launched the National Strategy for Financial Inclusion (NSFI) for 2019-2024**, an ambitious plan to strengthen the digital financial services ecosystem across India. This strategy focuses on smaller cities and towns, aiming to build the necessary infrastructure for a **cashless society by March 2022**.

Strategic Pillars of NSFI

- **Universal Access to Financial Services:** Ensuring that all individuals have access to basic financial services like savings accounts, credit, and insurance.
- **Effective Coordination:** Fostering collaboration among all stakeholders in the financial sector to achieve common goals.
- **Providing Basic Bouquet of Services:** Offering a range of essential financial services that cater to the diverse needs of different populations.
- **Customer Protection and Grievance Redressal:** Implementing robust measures to protect consumers from financial fraud and ensure their concerns are effectively addressed.
- **Financial Literacy and Education:** Empowering individuals with the knowledge and skills to make informed financial decisions.
- **Access to Livelihood and Skill Development:** Promoting opportunities for income generation and skill development to enhance financial stability.

Financial Inclusion: Transforming India's Financial Landscape

- **Increased Bank Account Penetration:**
  - According to the **World Bank's Global Findex report (2017)**, 80% of Indian adults now have bank accounts, compared to 53% in 2014. This represents a substantial leap in financial inclusion within just three years.
  - Notably, 77% of Indian women now have bank accounts, up from 43% in 2014. This signifies a major improvement in financial access and empowerment for women, who have traditionally been excluded from formal financial services.
- **Multiplier Effect:**
  - Initiatives like Jan Dhan Yojana and the expansion of digital payments have significantly improved last-mile connectivity, bringing financial services to previously excluded rural and remote populations.
  - This increased access to financial resources for marginalised communities has the potential to reduce poverty, create jobs, boost economic growth, and promote social inclusion.
- **Enhanced Participation of Private Players:**
  - Previously hesitant to engage with the poor as customers, private institutions are now actively participating in financial inclusion initiatives.
  - Payment banks like Paytm, Airtel Money, and Jio Money have recognized the potential of serving the unbanked population, realising that financial inclusion can be mutually beneficial for both customers and businesses.
- **Integration of Financial Services:**
  - The successful integration of the JAM trinity (Jan Dhan Yojana, Aadhaar, and Mobile) with the Direct Benefit Transfer (DBT) scheme has transformed the way government benefits are delivered.
  - This has resulted in targeted and accurate payments, eliminating duplicate entries and reducing reliance on cash, leading to greater efficiency and transparency.
- **Building a More Inclusive Economy:** These success stories demonstrate the transformative power of financial inclusion in India. By empowering individuals and fostering financial literacy, these initiatives lay the foundation for a more inclusive and equitable economy where everyone has the opportunity to participate and prosper.

Overall, India's journey towards financial inclusion serves as a model for other developing nations, demonstrating the potential of innovative policies, collaborative efforts, and technological advancements to create a more inclusive financial system for all.

Challenges of Financial Inclusion

- **Lack of Universal Bank Account Access:** Despite progress, millions in India remain unbanked, with estimates suggesting over 190 million adults lack bank accounts. This poses a significant barrier to accessing financial services and participating in the formal economy.

- **Digital Divide:** The adoption of digital financial services is hindered by various factors, including:
  - **Inadequate product availability:** Financial products tailored to the needs of low-income populations and informal businesses are often lacking.
  - **Digital skills gap:** Many individuals lack the necessary skills and knowledge to utilise digital financial services effectively.
  - **Infrastructure limitations:** Inadequate access to reliable internet connectivity and technology resources restricts digital adoption.
  - **Affordability:** Low-income individuals may struggle to afford smartphones and internet data plans, further exacerbating the digital divide.
- **Implementation Issues:** Initiatives like Jan Dhan Yojana have faced challenges, such as the prevalence of dormant accounts. This highlights the need for:
  - **Stronger follow-up mechanisms:** Ensuring active account usage and maximising program impact.
  - **Improved stakeholder engagement:** Encouraging all stakeholders to contribute meaningfully to financial inclusion efforts.
- **Informal Economy and Cash Reliance:** India's large informal sector and heavy dependence on cash transactions pose significant obstacles to digital financial inclusion. Building trust in digital platforms and incentivizing cashless transactions are crucial steps to overcome this challenge.
- **Gender Inequality in Financial Inclusion:** Gender disparity persists in access to financial services, with women lagging behind men in account ownership and utilisation. Addressing gender inequalities through targeted interventions and promoting financial literacy among women is essential.
- **Inadequate Credit Penetration:** Lack of credit information about low-income households and informal businesses hinders their access to credit. This necessitates:
  - Enhanced data collection and analysis: Building robust credit information systems to facilitate informed lending decisions.
  - Developing alternative credit scoring models: Exploring alternative methods to assess creditworthiness beyond traditional income verification.
- **High Cost of Credit:** The limited availability of credit combined with high-interest rates makes borrowing expensive for low-income individuals and informal businesses. Implementing policies to promote financial inclusion and encourage competition among lenders can help reduce borrowing costs.

Financial Inclusion Initiatives

Several key initiatives have been driving financial inclusion in India, leading to significant progress in recent years.

JAM Trinity

- **Jan Dhan Yojana (PMJDY):**
  - Over PMJDY Accounts have grown three-fold from 14.72 crore in March 15 to 50.09 (500 million) crore as on 16-08-2023 have joined the financial fold through PMJDY.
  - This ambitious initiative has opened bank accounts, granting access to financial services and paving the way for a more secure and prosperous future.
- **Aadhaar:**
  - This unique identification system, built on the bedrock of secure digital verification, simplifies and streamlines financial inclusion processes.
  - No longer are cumbersome paper trails and bureaucratic hurdles a barrier to accessing essential services.
- **Mobile Communication:**
  - The boom in mobile technology has become the wings that carry financial access to every corner of the country.
  - With smartphones in hand, citizens can now seamlessly manage their finances, conduct transactions, and connect with government services, even in the remotest villages.

Government Flagship Schemes

Recognizing the transformative power of financial inclusion, the government has launched a series of targeted schemes:

- **Pradhan Mantri Mudra Yojana:** This microloan scheme empowers small businesses, often run by women or marginalised communities, to flourish and contribute to the economic engine.
- **Stand-Up India Scheme:** Bridging the gender gap, this initiative fosters female entrepreneurship, providing women from underserved communities with the resources and support they need to build their dreams.
- **Life and Accidental Death Insurance Schemes:** PMJJBY and PMSBY offer affordable safety nets, protecting families from unforeseen circumstances and providing peace of mind.
- **Atal Pension Yojana:** Looking towards the future, APY builds a secure retirement for millions by offering a guaranteed minimum monthly pension, ensuring financial stability and dignity in golden years.

Reaching The Last Mile

The Reserve Bank of India (RBI) and National Bank for Agriculture and Rural Development (NABARD) have joined forces to ensure financial inclusion reaches every corner of the country:

- **Rural and Semi-Urban Expansion:** New bank branches sprout in remote areas, bringing financial services closer to rural communities.

- **Kisan Credit Cards:** Farmers gain access to vital agricultural loans through KCCs, empowering them to invest in their crops and increase yields.
- **Self-Help Group Integration:** Linking self-help groups (SHGs) with banks facilitates easier access to credit and financial resources, fostering collective economic growth.
- **ATMs and Business Correspondents:** The network of ATMs expands, while the business correspondent model brings banking services to doorsteps, ensuring last-mile connectivity even in the most remote areas.

Digital Payments

Technology plays a pivotal role in fueling the JAM Trinity's success:

- **Unified Payment Interface (UPI):** Secure and convenient digital transactions are now a reality with UPI, empowering individuals to pay and receive money with ease.
- **Aadhaar-enabled Payment System (AEPS):** Micro ATMs equipped with Aadhaar authentication allow for transactions anytime and anywhere, breaking down geographical barriers.
- **Offline Transaction Options:** Even without internet access, platforms like USSD banking empower individuals to manage their finances through their mobile phones.

Empowering Through Financial Literacy

Financial inclusion goes beyond mere access; it's about building financial knowledge and confidence. Initiatives like:

- **RBI's Project Financial Literacy:** This program educates diverse groups, from students to senior citizens, on banking, financial concepts, and responsible money management.
- **SEBI and NISM's Pocket Money:** Targeting schoolchildren, this initiative instills the principles of saving, investing, and financial planning early on, empowering them to make informed financial decisions in the future.

The JAM Trinity is more than just a set of programs; it's a transformative force that has empowered millions, bridged the gap between the unbanked and the mainstream, and laid the foundation for a more inclusive and prosperous India.

Key Strategies For Enhanced Financial Inclusion

While India has made significant strides in financial inclusion, further progress requires addressing key challenges and implementing effective strategies.

Here are some crucial steps to consider:

1. Reviving The Banking Correspondent Model

- Recognizing the limitations of physical bank branches, leveraging bank correspondents remains crucial for reaching remote areas.

2. Leveraging The JAM Trinity for Enhanced Credit Access

- Harnessing the power of Jan Dhan Yojana and Aadhaar can revolutionise credit assessment for underserved populations.

3. Strengthening Cybersecurity and Data Protection

- The increasing reliance on digital financial services necessitates robust cybersecurity measures and a strong data protection regime.
- Implementing necessary regulations and frameworks will protect individuals from cyber threats and ensure responsible data handling.

4. Leveraging Differentiated Banks for Scaled-Up Services

- Payment banks and small finance banks can play a pivotal role in expanding access to financial services in underserved areas.
- These specialised banks can offer tailored financial products and services, catering to the specific needs of low-income individuals and micro-enterprises.

5. Promoting USSD for Rural Financial Inclusion

- Utilising the Unstructured Supplementary Service Data (USSD) channel for financial transactions offers significant benefits, particularly in rural areas with limited internet access.

Financial inclusion is not merely a social welfare measure, but a strategic investment in the nation's future. By embracing technology, fostering collaboration, and viewing it as a business opportunity, we can create an inclusive financial ecosystem that empowers individuals, unlocks economic potential, and paves the way for a more prosperous and sustainable future for all.

Aspirational District Programme

The Aspirational Districts Program was launched in 2018, with the objective of expediting the transformation of most backward districts across 28 states through the convergence of government programmes and schemes. The focus is to improve India's ranking under Human Development Index, raising living standards of its citizens and ensuring inclusive growth of all.

The broad strategy of the Aspirational Districts Programme includes:

- **Convergence:** between Central and State Schemes
- **Collaboration:** between Centre, State, District Administration, Development Partners and Citizens
- **Competition:** between Districts

Key Features

A total of 112 Aspirational districts have been identified by NITI Aayog based upon composite indicators from Health & Nutrition, Education, Agriculture & Water

Resources, Financial Inclusion and Skill Development and Basic Infrastructure which have an impact on the Human development Index. Weightage has been accorded to these districts as below:

Themes, weight, and number of data-points

Theme	Weight	Data-points
Health & Nutrition	30%	31
Education	30%	14
Agriculture & Water Resources	20%	12
Financial Inclusion	5%	6
Skill Development	5%	10
Basic Infrastructure	10%	8
Total	100%	81

The objective of the program is to monitor the real-time progress of aspirational districts based on 49 indicators (81 data-points) from the five identified thematic areas with the latest available data from the ministries concerned.

Aspirational Blocks Programme (ABP)

It was launched on January 7, 2023, by NITI Aayog which aims to transform challenging and underdeveloped blocks in India. It includes 500 blocks from 329 districts across 27 States and 4 Union Territories.

- **Core Strategies:**
  - Convergence of existing schemes.
  - Defined measurable outcomes.
  - Continuous monitoring for progress.
- **Key Performance Indicators (KPIs):**
  - 40 KPIs grouped into five themes.
  - Baseline data sourced from March 31, 2023.
- **ABP Delta Rankings:**
  - Recent rankings based on improvements in the first quarter.
  - Tiriyani Block in Telangana tops the list.
  - Kaushambi Block in Uttar Pradesh secures the second position.
- **Recognition and Celebration:**
  - Introduction of the Wall of Fame at NITI Aayog.
  - Showcases achievements of Aspirational Blocks and Districts.
  - Reflects the vision to develop India by 2047.
- **Incentives and Competition:**
  - Winners felicitated with prize money.
  - Encourages holistic development.
  - Fosters a spirit of competition, collaboration, and convergence.
- **Overall Vision:** Aims for a more equitable and prosperous future for aspirational blocks in India.

SKILL DEVELOPMENT

Launched in 2015, the Skill India Mission is a landmark initiative by the Government of India aimed at equipping young people with essential skills for the job market. Its ambitious goal is to empower over 40 crore youth by 2022 by providing them with adequate training in market-relevant skills, fostering a skilled and employable workforce for the nation's future.

Objectives of The Skill India Mission

The Skill India Mission aims to empower youth and drive economic growth by focusing on the following **key objectives**:

- **Bridging the Skill Gap:** Reduce the discrepancy between industry skill demands and individual skill sets,enhancing employability and addressing workforce shortages.
- **Fostering Employment Opportunities:** Equip young people with essential skills to become productive members of the workforce, creating new employment opportunities and promoting economic growth.
- **Building a Global Workforce:** Develop the Indian youth into a globally competitive workforce, capable of meeting international skill standards and contributing to global markets.
- **Enhancing Business Competitiveness:** Empower Indian businesses with a skilled workforce, enabling them to compete effectively in the global market and contribute to national economic prosperity.
- **Cultivating Marketplace Capabilities:** Focus on building real-world skills and competencies relevant to industry demands,transcending mere qualifications to ensure job-readiness.
- **Adapting to Dynamic Market Needs:** Offer a diverse range of skill development programs that constantly evolve and adapt to the changing demands of the dynamic job market.
- **Addressing Skill Gaps in Critical Sectors:** Provide targeted training in areas like real estate, construction, transportation,textile, gem industry, banking, and tourism, where skill shortages exist.
- **Identifying Emerging Skill Needs:** Proactively identify new sectors and emerging technologies requiring skill development to prepare the workforce for the future.

Initiatives Taken For Skill Development

The Skill India Mission has implemented a comprehensive and multi-pronged approach to address the nation's skill development needs. Here's a breakdown of its key initiatives:

Pradhan Mantri Kaushal Vikas Yojana (PMKVY)

- **Target:** Unemployed youth and school dropouts.
- **Focus:** Short-term training across various sectors like retail, hospitality, IT, and construction, equipping individuals with job-ready skills.

- **Impact:** Over 10 million individuals trained since inception, with significant improvement in employability rates.
- **Additional Features:**
  - Multiple training tracks like Regular, Special Projects, and Upgradation & Skilling in Emerging Technologies (USSET).
  - Focus on financial inclusion through microloans for trainees.
  - Skill Recognition & Assessment (SRA) for certified skill development.

SANKALP (Skills Acquisition and Knowledge Awareness for Livelihood Promotion)

- **Target:** Rural areas and underserved communities.
- **Focus:** Building a robust skilling ecosystem at the district level by leveraging existing infrastructure and partnerships.
- **Impact:** Increased access to skill development opportunities for rural youth and women, leading to improved livelihoods.
- **Additional Features:**
  - Focus on demand-driven skills aligned with local industry needs.
  - Strong emphasis on community participation and ownership.
  - Leveraging existing vocational training centres and ITIs.

STRIVE (Strengthening Technical and Vocational Education and Training)

- **Target:** Industrial Training Institutes (ITIs).
- **Focus:** Upgrading infrastructure, curriculum, and training standards of ITIs.
- **Impact:** Enhanced quality and relevance of ITI training, making graduates more attractive to employers.
- **Additional Features:**
  - Introduction of industry-aligned courses and certifications.
  - Faculty development programs and skill upgrading for ITI instructors.
  - Collaboration with industry partners for internships and placements.

Beyond Individual Programs

India's skill development landscape extends beyond these flagship programs, with significant contributions from:

- **Inter-Ministry Collaboration:** Nearly 20 central ministries/ departments implement over 40 skill development programs, ensuring a diverse and comprehensive approach.
- **Corporate Social Responsibility (CSR):** Under the Companies Act, 2013, corporations have invested over ₹6,877 crores in diverse skilling initiatives, playing a crucial role in bridging the skill gap.
- International Initiatives**:** Projects like **TEJAS (Training for Emirates Jobs and Skills)** provide skilling and certification for overseas employment opportunities, particularly in the United Arab Emirates.

Program Components

- **Kaushal and Rozgar Mela:** These job fairs organised at local levels connect skilled individuals with employment opportunities, promoting transparency and community participation.
- **Recognition of Prior Learning (RPL):** This initiative recognizes and certifies the skills of individuals with prior experience, providing them access to further training and career advancement.
- **Special Projects:** Programs like **Pradhan Mantri Aadarsh Shahar Skill Development Mission** cater to specific skill requirements in sectors like urban development and waste management.

Quality Assurance

- **Monitoring Guidelines:** Ensure effective training and quality standards across designated training centres.
- **Placement Guidelines:** Assist individuals in finding suitable employment opportunities in alignment with their skills and market demands.

Achievements of The Skill India Mission

The Skill India Mission has achieved significant milestones since its inception, empowering millions of individuals through skill training and development. Here are some noteworthy achievements:

- **Large-Scale Skill Development:**
  - Over 2.5 crore people have received skill training since 2009-2020, demonstrating the mission's impact and reach.
  - The flagship PMKVY program alone has trained over 1.37 crore individuals and certified over 1.1 crore, contributing significantly to the national skill development agenda.
  - PMKVY 4.0 is currently running, continuing the program's success and ensuring ongoing skill development opportunities.
- **Expanding Apprenticeship Opportunities:** The **Pradhan Mantri National Apprenticeship Melas (PMNAM)** provide local youth with access to diverse apprenticeship training, bridging the gap between theoretical knowledge and practical on-the-job experience.
- **Drone Training Initiative:** 126 Government Industrial Training Institutes (ITIs) have been approved to offer courses on operating drones, equipping individuals with the skills and knowledge for this rapidly expanding industry.
- **Promoting Inclusive Skill Development:** To ensure inclusivity, 100% boarding and lodging facilities were

provided to candidates from the Northeastern states and Left-Wing Extremism (LWE) affected areas, facilitating their participation in short-term training programs.

- **International Collaboration:** Recognizing the global demand for skilled workers, the **Ministry of Skill Development & Entrepreneurship (MSDE)** partnered with the **Ministry of External Affairs (MEA)** to enable the deployment of skilled Indian workers abroad. MoUs/ Agreements have been signed with more than 11 countries, opening doors to international employment opportunities.
- **WorldSkills Competition:** India's ranking in the prestigious WorldSkills Competition 2022 improved to 11th, demonstrating the effectiveness of the Skill India Mission in fostering excellence in skilled trades.
- **Specialised Skill Initiatives:** In collaboration with the Armed Forces, the MSDE has implemented specialised skill development initiatives, empowering veterans and transitioning them into civilian careers.

Challenges Faced by The Skill India Mission

Despite its achievements, the Skill India Mission faces several challenges:

- **Overburdened Responsibility:**
  - Phase III of PMKVY, aiming to train over 8 lakh individuals, relies heavily on District Skills Development Committees chaired by District Collectors.
  - This creates a burden on already overloaded officials, potentially impacting the effectiveness of program implementation.
- **Discontinuity in Policy Process:**
  - The National Skill Development Agency (NSDA), established in 2013 to resolve inter-departmental issues and eliminate duplication of effort, has been subsumed under the National Council for Vocational Education and Training.
  - This raises concerns regarding policy continuity and potential confusion among policymakers.
- **Enormous Number of New Entrants:**
  - A 2019 NSDC study estimates that 7 crore additional individuals will enter the workforce by 2023, requiring significant skilling efforts to meet the demand.
  - Existing programs may be inadequate to address this scale of skill development needs.
- **Employers' Unwillingness:**
  - India's unemployment issue extends beyond just a skills gap.
  - Limited access to credit due to non-performing assets in banks has led to a decline in investment and consequently, hampered job creation.
  - Employers' lack of appetite for recruitment further exacerbates the issue.
- **Addressing These Challenges Requires:**
  - Decentralisation of responsibilities and delegation of tasks.
  - Enhanced coordination and collaboration across different departments and ministries.
  - Scaling up skill development programs to accommodate the increasing number of job seekers.
  - Addressing the credit crisis and encouraging investment to stimulate job creation.
  - Encouraging employers to invest in training and recruitment of skilled workforce.

Way Forward

Investing in skill development is crucial for India's continued progress. With a vast young population, India boasts a significant "demographic dividend," offering an immense potential for supplying skilled manpower to the labour market. This endeavour requires a concerted effort from all stakeholders, including:

- **Government Agencies:** They play a vital role in setting policy frameworks, allocating resources, and providing infrastructure for skill development initiatives.
- **Industries:** Businesses need to actively participate in identifying skill gaps, shaping training programs, and offering employment opportunities for skilled individuals.
- **Educational and Training Institutes:** These institutions should adapt their curricula to meet industry demands and provide high-quality training programs that equip individuals with the necessary skills.
- **Students, Trainees, and Job Seekers:** Individuals must actively engage in skill development programs, continuously upgrade their skills, and remain adaptable to changing market demands.

Only through a collaborative effort from all stakeholders can India harness its demographic dividend and reap the full benefits of a skilled and employable workforce. This will contribute significantly to economic growth, social development, and overall national progress.

Human Capital Formation

Human capital is the invisible asset of a workforce, representing the economic value of an individual's experience, skills, and knowledge. It encompasses not just formal education and training, but also inherent intelligence, diverse skills, health, and even character traits like loyalty and punctuality.

Unlike tangible assets on a balance sheet, human capital is intangible. However, its impact is undeniable. Investing in human capital is investing in productivity, which ultimately translates to increased profits and success for organisations. The more a company empowers its people, the better it positions itself for growth and prosperity.

Human Capital and Economic Growth

- **Investment in Education:** When individuals have access to quality education and training, they develop valuable skills and knowledge, leading to higher productivity and innovation. This translates to increased output, improved efficiency, and ultimately, economic growth.
- **Higher Wages and Increased Spending:** Individuals with higher levels of education tend to earn better salaries, enabling them to spend more on goods and services. This increased demand stimulates businesses, creates jobs, and contributes to economic expansion.
- **Technological Advancement:** A skilled and adaptable workforce is essential for embracing technological advancements. When individuals are equipped with the necessary skills to utilize new technologies, it leads to increased productivity,efficiency, and innovation, further fueling economic growth.

Depreciation of Human Capital

While human capital can be a powerful force for economic growth, it is not immune to depreciation. Just like physical assets, human capital can deteriorate over time due to various factors, including:

- **Unemployment:** Long periods of unemployment can lead to skill erosion and knowledge gaps, making it challenging to re-enter the workforce and contribute effectively.
- **Injury or Disability:** Physical or mental health limitations can significantly reduce an individual's capacity to work, impacting their productivity and economic contribution.
- **Cognitive Decline:** As individuals age, cognitive abilities may decline, affecting their ability to learn new skills and adapt to changing work environments.
- **Technological Change:** Rapid technological advancements can render certain skills obsolete, requiring individuals to continuously update their knowledge and acquire new skills to remain competitive.

Strategies to Mitigate Depreciation

- **Lifelong Learning:** Encouraging individuals to engage in continuous learning and skill development throughout their careers can help them stay relevant in the face of changing technological landscapes.
- **Training and Reskilling Programs:** Providing accessible and affordable training programs can equip individuals with the necessary skills to adapt to new technologies and remain employable.
- **Flexible Work Arrangements:** Implementing flexible work arrangements can accommodate individuals with health limitations or age-related challenges,enabling them to continue contributing to the workforce.
- **Investment in Health and Wellbeing:** Promoting healthy lifestyles and access to healthcare can help individuals maintain their physical and mental health, allowing them to participate effectively in the workforce for longer periods.

India's Demographic Dividend: Opportunities and Challenges

Changing Demographics

- **Fertility Decline:** India's Total Fertility Rate (TFR) has fallen below the replacement level of 2.1, indicating slowing population growth.
- **Ageing Population:** Despite lower TFR, population growth will continue due to population momentum and increasing life expectancy.
- **Shifting Age Structure:** The share of the young population (0-19 years) is declining, while the elderly population (60+ years) is increasing.
- **Growing Working Age Population:** India's working age population (20-59 years) will continue to grow until 2041, peaking around that time.

Demographic Dividend Potential

- **Increased Labor Force:** A larger working-age population can boost economic growth through increased labour supply and productivity.
- **Higher Savings and Investments:** This demographic shift can lead to higher savings and investments, further fueling economic expansion.
- **Opportunity for Economic Growth:** India's demographic dividend presents a unique opportunity to catch up to developed economies in terms of per capita income.

Challenges and Heterogeneity

- **Skill Development:** Equipping the growing workforce with relevant skills is crucial for maximising the dividend.
- **Job Creation:** Creating enough jobs for the expanding workforce is essential to prevent unemployment and social unrest.
- **Regional Disparities:** Different Indian states exhibit varying demographic profiles, requiring tailored policy approaches.
- **Ageing Concerns:** Preparing for the needs of a growing elderly population is another important challenge.

Policy Response and Opportunities

- **Three-Dimensional Approach:** The government's combined focus on growth, poverty alleviation, and basic amenities can facilitate a positive demographic transition.
- **Labour Mobility:** Encouraging labour mobility between states with varying demographic structures can help address regional imbalances.

- **Education and Skill Development:** Investing in education and skill development programs is crucial for preparing the workforce for the future economy.
- **Social Security:** Building robust social security systems will provide support for the elderly population.

SHYAMA PRASAD MUKHERJI RURBAN MISSION

In **2016, the Ministry of Rural Development launched the Shyama Prasad Mukherji Rurban Mission (SPMRM)** to tackle the significant disparities between rural and urban India. With 69% of the population residing in rural areas, yet contributing just 14% to the GDP compared to 26% and 60% for industries and services respectively, the need for rural transformation was clear.

Vision and Approach

SPMRM seeks to transform rural landscapes by developing Rurban Clusters, geographically contiguous groups of villages showing signs of urbanisation. These clusters, with populations ranging from 25,000 to 50,000, hold immense potential for economic growth.

Key Features

- **Integrated Project-Based Infrastructure:** SPMRM provides economic, social, and physical infrastructure within Rurban Clusters. This includes the development of essential services like roads, water supply, and sanitation, as well as facilities for skill development, healthcare, and education.
- **Focus on Economic Activities:** The mission promotes non-farm employment opportunities by encouraging the development of industries, tourism, and handicraft production within Rurban Clusters.
- **Scientific Cluster Selection:** States, in accordance with the MoRD's framework, identify Rurban Clusters based on objective criteria like population density, economic potential, and existing infrastructure.
- **Significant Progress:** As of now, 291 Integrated Cluster Action Plans (ICAPs) and 282 Detailed Project Reports (DPRs) have been developed, with a proposed investment of over Rs. 27,000 crores. Additionally, more than half of the planned projects are either completed or near completion.

Significance and Potential

SPMRM Aims To

- **Reduce Urban Migration:** By offering opportunities and improving living standards in rural areas, SPMRM discourages migration to urban centers.
- **Boost Rural Economy:** The focus on economic development and skill building empowers individuals and encourages entrepreneurship, leading to a stronger rural economy.
- **Transformational Development:** SPMRM aims to create sustainable and self-sufficient rural communities, fostering long-term progress and prosperity.

Approach to Rural Development

SPMRM goes beyond merely providing basic infrastructure. It aims to create self-sufficient clusters called "Rurban Clusters" through integrated project-based development. These clusters, formed from geographically contiguous villages, focus on:

- **Economic Activities:** Promoting non-farm employment opportunities through skill development, industrialization, and entrepreneurship.
- **Social Infrastructure:** Providing access to quality education, healthcare, clean water, sanitation, and other essential services.
- **Physical Infrastructure:** Developing connectivity through roads, bridges, and digitalization.

Rurban Clusters

Rurban clusters are essentially a group of 15-20 villages with populations ranging from 25,000 to 50,000 in plain and coastal areas and 5,000 to 15,000 in desert, hilly, or tribal regions. States identify these clusters based on specific criteria like population density, economic potential, and growth indicators, ensuring a scientific and objective selection process.

CONCLUSION

Inclusive growth is not just an ethical imperative but a pragmatic strategy for sustainable economic development. It involves a multi-dimensional approach that goes beyond income metrics to encompass social, environmental, and governance aspects, ultimately leading to a more equitable, resilient, and prosperous society.

Inflation

6

INTRODUCTION

Inflation may be defined as a sustained rise in the general level of prices or, persistent increases in the general level of prices or, an increase in the general level of prices in an economy that is sustained over time, and rising prices across the board.

The measurement of Inflation is done point-to-point, which means that the reference date for the annual inflation is from January 1st to January 1st of the two consecutive years (not January 1st to December 31st of the year concerned). Similarly, the weekly rate of inflation is the change in one week reference being the two consecutive last days of the week (i.e., 5 p.m. of two Fridays in India).

Types of Inflation

Inflationary situations may be classified on the basis of different considerations. We may distinguish between different types of inflation on the basis of the degree or speed with which the prices rise.

Classification Based on The Degree of Price Rise

- This inflation is manageable and good for economy as producers and traders make reasonable profits which encourage them to invest more.
- **Low inflation:** It takes place over a longer period, and the range of increase is usually in a **'single digit'**. It is also called '**creeping inflation**' since it rises over time.
- **Walking Inflation:** It acts as warning for the occurrence of running/galloping inflation. It is also called trolling inflation and rate of rising prices is more than creeping inflation.
- **Galloping inflation:** This is a very high inflation running in the range of **double or triple digits** (i.e., 20 %, 100 %, or 200 % in a year). For example - Russia in the late 1980s. This causes businesses and employees' income not at par with the costs and the prices. It has also been given some other names, such as - *hopping inflation, jumping inflation, and running or runaway inflation*.
- **Hyperinflation:** This form of inflation is large and accelerating which might have the **annual rates in million or even trillion**. In such inflation not only the range of increase is very large, but the increase takes place in a very short span of time, where prices shoot up overnight.

  Examples- Germany after the first world war in the early 1920s, Zimbabwe during 2004-09, and Venezuela.

  Such an inflation rate leads to a complete loss of confidence in the domestic currency, and people start opting for other forms of money, for example, physical assets, gold, and foreign currency, also known as 'inflation-proof' assets and people might switch to barter exchange.

Classification Based on The Processes

- **Deficit-induced inflation:** It is caused by the adoption of deficit financing or by government spending in excess of its revenue receipts.
- **Wage-induced inflation:** It is caused by an increase in money wages.
- **Profit-induced inflation:** It occurs on account of an increase in the profits of the manufacturers.
- **Peace-time inflation:** It refers to the rise in prices during periods of peace resulting from increased government outlays.
- **Sporadic inflation:** It is of a sectional nature, occurring due to an abnormal shortage of some specific goods. A typical case of sporadic inflation would be an increase in prices of food products as a result of crop failure.

Types of Inflation (Cause-Wise)

These can be categorized under three categories:

- **Demand-pull inflation:** It emerges when the aggregate demand exceeds the level of supply or output.
  - Consumers and investors seek to buy more than the total amount of output that can be produced. This type of inflation is also known as **excess demand inflation.**
  - **Causes:** An increase in the quantity of money would lower the rate of interest which would stimulate investment.
    - Increased private and government spending,
    - Lower rate of savings by households,
    - Depreciation in local exchange rate,
    - Reduction in taxes and
    - Lincrease in money supply and bank credit.
    - The demand-pull inflation can also occur without an increase in money supply. This would occur when aggregate demand increases either because of a rise in the marginal efficiency of capital or a **rise in the propensity to consume** (Ex - Demand increase from D1 to D5 in the figure leads to an increase in prices).

- **Cost-Push Inflation:** In this, inflation occurs due to increase in the cost of "factors of production" of goods and services such as land, labour and raw materials. It is caused mainly by three factors in wage rate,
  - An increase wage rate,
  - An increase in profit margin, or
  - An increase in material costs.
    - For example, when rapidly rising money wages are not accompanied by corresponding increases in productivity in certain key sectors of the economy, resulting in higher prices in these sectors.
    - Increase in indirect taxes,
    - Increase in import prices and
    - Higher cost of capital and interest rates.
- **Structural Inflation:** In this case, inflation persists for longer due to the following economic weaknesses:
  - Sluggish agriculture sector with low production;
  - Ineffective facilities for distribution and storage; etc.
  - This can also be referred as the "bottleneck inflation" and is manageable with significant structural changes.

Other Variants of Inflation

- **Headline Inflation:** It is a measure of the total inflation within an economy, including commodities such as food and energy prices (e.g., oil and gas), which tend to be much more volatile and prone to inflationary spikes.

IGNITE YOUR MIND

Do you think that the classification of inflation based on the degree or speed of price rise provides a meaningful understanding of inflationary scenarios?

- **Core Inflation:** It is based on the inclusion or exclusion of goods and services while calculating inflation. It shows price rise in all goods and services, **excluding** energy and food articles. It is quite popular in western economies. It was first used in 2000-01 in India but later fell out of fashion as prices in India depend more on food articles and energy requirements. Since 2015-16, new **core-core** inflation is also measured by India, which excludes food, fuel, light, transport, and communication.
  - **Refined core inflation:** Economic Survey 2022 introduced the concept of refined core inflation. The Survey says that a "refined" Core inflation has been constructed to exclude the volatile fuel items. The items of "petrol for a vehicle," "diesel for a vehicle," and "lubricants & other fuels for vehicles", in addition to "food and beverages" and "fuel and light," have been excluded from headline retail inflation.

Key Terms

- **Inflationary Gap:** The excess of total government spending above the national income (i.e., fiscal deficit) is known as the inflationary gap. This is intended to increase the production level, which ultimately pushes the prices up due to the extra-creation of money during the process.
- **Deflationary Gap:** The shortfall in total spending of the government (i.e., fiscal surplus) over the national income creates deflationary gaps in the economy. This is a situation of producing more than the demand and slowdown in the economy. It is also known as the **'output gap'.**
- **Inflation tax:** The inflation tax is an implicit tax imposed (penalty for retaining money) on money holders due to the effects of inflation. That means it is a tax on the real value of their money because inflation erodes the purchasing power of money over time.
  - In this situation, the government alters the money supply in the market (as in the case of deficit financing). The government increases the money supply, resulting in a form of tax on existing money holders. This looks as if inflation is working as a tax.
- **Inflation spiral:** An inflationary situation in an economy that results from a process of wage and price interaction 'when wages press prices up and prices pull wages up is known as the inflationary spiral. It is also known as the **wage-price spiral**.
- **Inflation premium:** An inflation premium is the **extra interest rate** demanded by investors in addition to the real risk-free rate to compensate for the risk of inflation.
  - Inflation brings a bonus to the borrowers and loss for the lender and thus the lender demands an extra interest rate on lending which is known as the inflation premium.
- **Reflation:** Reflation refers to a fiscal or monetary policy (or policies) aimed towards stimulating the economy (i.e., increasing the level of economic activity) and combating deflation.

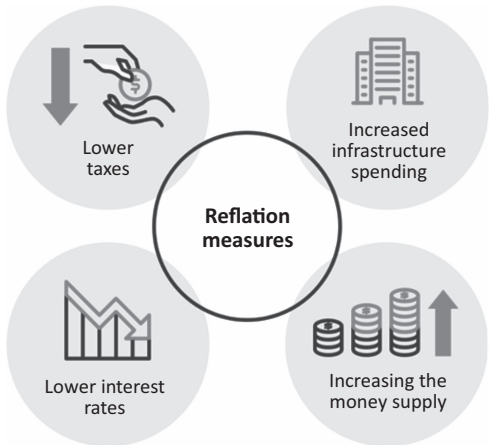


Fig. 6.1: Reflation Measures

- **Stagflation:** Stagflation is a situation in an economy when **inflation and unemployment** both are at higher levels, contrary to conventional belief. It is a situation in which economic policymakers may find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.
- **Shrinkflation:** The process of reducing the size or quantity of product while the price of product remains the same or slightly increases. It is widely used by producers in the food and beverage industry.
- **Skewflation:** It means the skewness of inflation among different sectors of the economy — some sectors are facing huge inflation, some none and some deflation.
- **Deflation:** Deflation refers to falling prices; or in other words, the opposite of inflation (rising prices). It is what happens when the inflation rate falls but remains positive.
- **Disinflation:** It denotes a deceleration in the pace of inflation, characterized by a moderation in the rate of price increases, yet retaining a positive trajectory. It occurs when prices continue to grow but at a slower rate than before.

Basis	Disinflation	Deflation
Meaning	When the rate of inflation slows temporarily	When there is a fall in the general price level
Frequency	More frequent	Less frequent
Factors	Due to a pull down in the business cycle, use of tight monetary policy, etc.	Drop in consumer spending. investment, money supply, govt. expenditue, etc.
Example	Almost every economy go through this.	The Great Depression in the 1930s
Stock Markets	The stock market may or may not go down.	Stock market doesn't perform well and witnesses a drop.
Impact	It isn't believed to be negative for the economy	Deflation isn't good for the economy
Economy	Positive and stable.	Weaker and negative
Time period	Will continue until the inflation rate is zero	Will continue until inflation rate is positive or zero

- **Inflation Accounting:** It is a term popular in the area of corporate profit accounting. Basically, due to inflation the profit of firms/companies gets overstated. When a firm calculates its profits after adjusting the effects of current level of inflation, this process is known as inflation accounting. Such profits are the real profit of the firm which could be compared to a historic rate of inflation (inflation of the base year), too.
- **Phillips curve:** It is a graphic curve which advocates a relationship between inflation and unemployment in an economy.

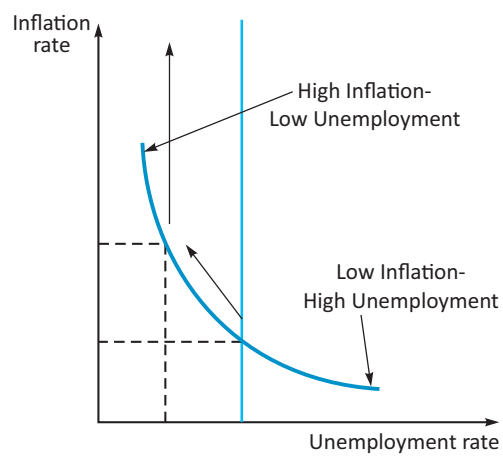


Fig. 6.2: Phillips Curve

  - As per the curve there is a **'tradeoff' between inflation and unemployment**, i.e., an inverse relationship between them. The curve suggests that lower the inflation, higher the unemployment and higher the inflation, lower the unemployment.
  - However, in later stages it was argued (Friedman and Phelps) that the Phillips curve was only applicable in the short run and that, in the long run, inflationary policies would not decrease unemployment.
  - **Later theories on the inflation-unemployment relationship:** In the 1970s, new theories, such as rational expectations and the **NAIRU (non-accelerating inflation rate of unemployment)** arose.
- **Non-Accelerating Inflation Rate of Unemployment (NAIRU):** It is the specific level of unemployment that is evident in an economy that does not cause inflation to increase.
  - In other words, **if unemployment is at the NAIRU level, inflation is constant**. NAIRU often represents the equilibrium between the state of the economy and the labor market.
  - It is the lowest unemployment rate that an economy can sustain without any inflationary pressures.

METHODS OF MEASURING INFLATION IN INDIA

Every economy calculates its inflation for efficient financial administration as the multi- dimensional effects of inflation makes it necessary. India calculates its inflation on two price indices, i.e., the WPI and the CPI. While the WPI inflation is used at the macro-level policymaking, the CPI inflation is used for micro- level analysis. Both the indices follow the 'point to point' method and may be shown in points as well as in percentage relative to a particular base year.

Wholesale Price Index (WPI)

WPI measures the average change in prices of goods at the wholesale level.

- The first index number of wholesale prices commenced in India for the week January 10, 1942. Independent India followed the same series with more commodities included in the index.
- Several changes regarding inclusion of commodities, assigning them the logical weights took place in the coming years including revisions in the base years for the WPI.
- Current Base Year 2011-12 (697 commodities). It was revised in May 2017.
- The WPI includes - primary articles, fuel & power and manufactured products.

Note: Both WPI and CPI are price indices. In other words, these are two different baskets of goods and services.

The government assigns different weights to different goods and services based on what is relevant for those two types of consumers.

Major Groups and Their Weights (2011-12)

Major Group/ Group	Weight	No. of items	No. of Quotations
All Commodities	100.00	697	8331
Primary Articles	22.62	117	983
Fuel and Power	13.15	16	442
Manufactured Products	64.23	564	6906

Revised WPI: The new series of the WPI was released by the Government with the **revised base year** as 2011-12. The existing base year was 2004-05. The new base year aligns with the base year of other indicators like the Gross Domestic Product (GDP) and Index of Industrial Production (IIP). Step taken to revise and change the method of WPI:

- A Working Group was set up (March 2012) by the Government to advise on the new series of the WPI (headed by **Saumitra Chaudhuri**, Member, erstwhile Planning Commission). Key highlights of the revised series are as given below:
  - WPI **continues to constitute three major groups**—Primary Articles, Fuel and Power, and Manufactured Products. The number of items has been increased from 676 to 697.
  - It is **more representative** with an increase in the number of quotations from 5482 to 8331.
  - The prices used for compilation **do not include indirect taxes** in order to remove the impact of fiscal policy.
  - A new **Wholesale Food Price Index (WPFI)** has been introduced—combining Food Articles (belonging to the group Primary Articles) and Food Products (belonging to the group Manufactured Products). Together with the Consumer Food Price Index (CPFI) released by the Central Statistics Office, this would help monitor the price situation of food items better.

Major Group/Group	Weight		No. of items		No. of Quotations	
	2004-05	2011-12	2004-05	2011-12	2004-05	2011-12
All Commodities	100.00	100.00	676	697	5482	8331
Primary Articles	20.12	22.62	102	117	579	983
Fuel & Power	14.91	13.15	19	16	72	442
Manufactured Products	64.97	64.23	555	564	4831	6906

- To keep pace with the changing structure of the economy, it is necessary to follow a dynamic review process of the WPI and related aspects of it. That is why the Government has set up a **Technical Review Committee** headed by Secretary of DIPP.

Also, a **Working Group** (headed by Ramesh Chand, member Niti Aayog) was set up by the government in mid-2019 to look into various issues related to the WPI, such as revising the current series of 2011-12 to a new base year; reviewing its commodity basket; reviewing the existing system of price collection in particular for manufacturing sector and suggesting changes for improvement; and suggesting a roadmap to switch over to PPI from the existing WPI.

Consumer Price Index (CPI)

CPI calculates the average change in prices of goods and services at the retail (consumer) level. Depending upon the socio-economic differentiations among consumers (i.e. people's choices of consumption and their purchasing power), India was using **four different sets of CPI** with some differentials in the basket of commodities allotted to them. Though in 2011-12 the government announced a new set of consumer indices (i.e., CPI-R, CPI-U and CPI-C), datasets for the older CPIs (to be phased out in coming times) are still announced by the National Statistical Office (NSO). A brief introduction of the older CPIs is given below:

- **Consumer Price Index for the industrial workers (CPI-IW):** It is compiled by the Labour Bureau on a monthly basis which measures changes in the retail prices of a

fixed basket of goods and services (a total of 463 items) being consumed by an average working-class family. To capture the latest consumption pattern, the base year of the index was revised to 2016 (from 2001) in October 2020.The index is used for fixing/revising wages, regulating the DAs of manual workers and employees of central and state governments.

- **Consumer Price Index for the Urban Non-Manual Employees (CPI-UNME):** It has limited use, and it is used for determining DAs of employees of some foreign companies operating in India (i.e., airlines, communications, embassies etc.).It is also used under the Income Tax Act to determine capital gains. Since the publication of the CPI (U) started, the index was discontinued from January 2011.
- **Consumer Price Index for Agricultural Laborers (CPI-AL):** This index is used for revising minimum wages for agricultural laborers in different states. The governments at the Centre and states remain vigilant regarding the changes in this index as it shows the price impact on the most vulnerable segment of the society; this segment spends almost 75% of its total income on the purchase of food articles. Governments' failure to stabilise the index in the long range can make them politically volatile and be translated into political debacles. That is why the FCI is always kept ready to supply cheaper foodgrains in the situations of any price rise.
- **Consumer Price Index for the Rural Labourers (CPI-RL):** While the retail prices utilized in the compilation of CPI-AL and CPI-RL are same, the weights are different due to the difference in coverage of the two series. The coverage of CPI-AL is confined to households of the agricultural labourers whereas the CPI-RL is CPI-AL covers the households of rural labourers which includes agricultural labourers households also.
- **Consumer Price Index (Rural+Urban) or CPI (Combined):** In 2011-12, Government announced a new set of the consumer price indices - CPI-R for the rural market, CPI-U for the urban market, and by combining them a 'national' CPI. The national CPI is called CPI- Combined. The CPI-C serves as a key measure for the RBI's inflation-targeting framework. The central bank uses this index to guide its monetary policy decisions and aims to maintain inflation within a predetermined target range to promote price stability and sustainable economic growth. Regular monitoring of CPI-C data helps the RBI make informed decisions on interest rates and other policy measures.

Index	Base Year Used	Compiled by
CPI-IW	2016	Labour Bureau (Ministry of Labour & Employment)
CPI-AL	1986-87	
CPI-RL	1986-87	
CPI-Combined	2012	National Statistical Office (NSO)

Revision in The CPI

In order to make them more robust, the CPIs were further revised in 2015 by incorporating the following changes:

- The Base Year has been changed from 2010=100 to 2012=100. (The series on Base 2010=100 and 2012=100 have hereinafter been named as old series and revised series respectively.
- The basket of items and their weighing diagrams have been prepared using the Modified Mixed Reference Period (MMRP) data of Consumer Expenditure Survey (CES), 2011-12, of the 68th Round of National Sample Survey (NSS). This has been done to make it consistent with the international practice of shorter reference period for most of the food items and longer reference period for the items of infrequent consumption/purchase
- The number of Groups, which was five in the old series, has now been increased to six. 'Pan, tobacco and intoxicants', which was a Sub-group under the Group 'Food, beverages and Tobacco', has now been made a separate Group. Accordingly, the Group 'Food, beverages and Tobacco' has been changed to 'Food and beverages'.
- Egg, which was part of the Sub-group 'Egg, fish and meat' in the old series, has now been made as a separate Sub-group. Accordingly, the earlier Sub-group has been modified as 'Meat and fish'.
- The elementary price index are now being computed using Geometric Mean (GM) of the Price Relatives of Current Prices with respect to Base Prices of different markets in consonance with the international practice. In the old series, Arithmetic Mean (AM) was used for that purpose. The advantage of using GM is that it moderates the volatility of the indices since GM is less affected by extreme values.
- Prices of PDS items under Antyodaya Anna Yojana (AAY) have also been included for compilation of indices of PDS items, in addition to Above Poverty Line (APL) and Below Poverty Line (BPL) prices being taken in the old series.
- Sample size for collection of house rent data for compilation of House Rent Index, which was 6,684 rented dwellings in the old series, has now been doubled to 13,368 rented dwellings in the revised series.
- Apart from All-India CPIs (Rural, Urban, Combined) for Sub-group, Group and General Index (All-Groups), which were released for the old series, all India Item CPIs (Combined) would also be available in the public domain for the users. These item level indices would be put on the web portal of this Ministry (www.mospi.gov.in) one day after the press release on CPI.

Basis of Comparison	WPI	CPI
Meaning	Index which shows inflation at the wholesale level	Index which shows inflation at the consumer level
Commodities	Goods only	Goods and Services both
Weightage	Manufactured goods	Food Items
Publishing office	Office of Economic Advisor (MoC&I)	National Statistical Office (MoS&PI)
Base Year	2011-12	2012
Total number of items covered	697 items	448 items in rural and 460 items in urban

GDP Deflator

- The GDP deflator, also called implicit price deflator, is also another measure of inflation. It is the ratio of the value of goods and services an economy produces in a particular year at current prices to that of prices that prevailed during the base year.

GDP price deflator = (nominal GDP ÷ real GDP) x 100

OR

GDP deflator = GDP at current prices/GDP at constant prices

Note:

- If the GDP deflator is 1, it implies no change in general price levels.
- If the GDP deflator is > 1, it implies an increase in general price levels.
- If the GDP deflator is < 1, it implies deflation or reduction of prices across the economy.

IGNITE YOUR MIND

Do you think India's reliance on both WPI and CPI for inflation measurements offers a comprehensive picture of price pressures, or does it create complexities and potential inconsistencies?

IMPACTS OF INFLATION

There are multi-dimensional effects of inflation on an economy both at the micro and macro levels.

On consumers (general people)	An overall rise in prices over time **reduces the purchasing power** of consumers and thus **reduces the aggregate demand** in the economy.
On Creditors/ Lenders and Debtors	Inflation benefits the borrowers (debtors) and causes loss to the lender (creditor).
On Investment	Investment in the economy is boosted by inflation (in the short-run). When prices rise, producers, traders, speculators and entrepreneurs gain on account of windfall profits because prices rise at a faster rate than the cost of production. Besides, there is a time -lag between the price rise and the increase in cost. Moreover, producers gain because the prices of their inventories (stocks) go up due to inflation. Also they generally, being borrowers of money for business purposes, stand to gain.
On Income/fixed income group	Wage earners generally suffer during inflation, despite the fact that they obtain a wage rise to counter the rise in the cost of living. However, wages do not rise as much as the rise in prices of those commodities which the workers consume. Further, wages are allowed to rise much later than the rise in prices. If the workers are organized, they may not suffer much during inflation but if they are unorganized (like the agricultural laborers) they may suffer more as they may not find it easy to get their wages increased.
On Saving	Holding money does not remain an intelligent economic decision (because money loses value with every increase in inflation) which is why people visit banks more frequently and try to hold less money with themselves and put maximum with the banks in their savings accounts. This is also known as the **shoe leather cost of inflation** (as it consumes the precious time of the people visiting the bank frequently tagging their shoe).

On Tax	Tax-payers suffer while paying their direct and indirect taxes. Indirect taxes are imposed on value that increases prices of goods make tax-payers to pay increased indirect taxes. Similarly, due to inflation, direct tax (income tax, interest tax, etc.) burden of the tax-payers also increases as **tax-payer's gross income moves to the upward slabs** of official tax brackets (but the real value of money does not increase due to inflation; in fact, it falls). This problem is also known as **bracket creep -** i.e., inflation-induced tax increases.
On Exchange Rate	With a rise in inflation, the currency of the economy depreciates (loses its exchange value in front of a foreign currency) provided that it follows a flexible currency regime.
On Export	With inflation, exportable items of an economy gain competitive prices in the world market. Due to this, the volume of export increases (keep in mind that the value of export decreases here) and thus export income increases in the economy.
On Import	Inflation gives an economy the advantage of lower imports and import-substitution as foreign goods become costlier. But in the case of compulsory imports (i.e., oil, technology, drugs, etc.) the economy does not get this benefit and loses more foreign currency instead of saving it. Ex - India is dependent on crude oil import and thus faces huge losses during inflation.
On Trade Balance	In the case of a developed economy, inflation makes the trade balance favorable, while for developing economies, inflation is unfavorable for their balance of trade. For example - India, during inflation, exports more compared to normal times, but because of its import dependence on crude oil it pays more compared to its exports thus, leading to an adverse impact on its Current Account Deficit (CAD)
On Employment	Inflation increases employment in the short-run, but becomes neutral or even negative in the long run.
Public morale	Inflation results in arbitrary redistribution of wealth favoring businessmen and debtors and hurting consumers, creditors, petty shopkeepers, small investors, and fixed income earners. This lowers the public morale.

HEALTHY RANGE OF INFLATION

In the late 1980s, rich countries began to doubt the idea of balancing higher inflation and higher growth because they saw that it caused problems with the economy and society. They realized that dealing with the economic and social costs of higher inflation required policy attention, making it a costly "trade-off".

In the coming times, most of the world economies opted in favor of a stable inflation (i.e., inflation targeting). India also started with this trend of inflation stabilization (informed targeting at WPI) by the early 1970s.

Different committees had recommended a suitable range of inflation at different point of time:

- The **Chakravarty Committee (1985)** treated 4% inflation as acceptable for the economy.
- The Govt. accepted a range of 4 % to 6% inflation as acceptable for the economy citing the world average of 0 to 3% at the time (1997-98).
- The RBI Governor C. Rangarajan advocated that the inflation rate must come down initially to 6-7% and eventually to 5-6% on an average over the years.
- The **Tarapore Committee on Capital Account Convertibility (1997)** recommended an acceptable range of 3 to 5 % inflation.
- June 2003 onwards, the government/ the RBI maintained a general policy of keeping inflation below 5% - at any cost - as if fixing 4 to 5% as the healthy range of inflation for the economy.

In February 2015, India formally commenced the process of 'inflation targeting'. Now, the new monthly CPI (C) is taken as the measure of headline inflation and is tracked by the RBI to anchor its monetary policy, and the healthy annual range for it is between 2 and 6%.

CONTROL OF INFLATION

Control of inflation should involve monetary and fiscal steps aiming at reducing the level of aggregate demand so as to equate it with the full employment output in the economy. The level of investment or consumption or both may be curtailed by increasing the number and the rates of direct and indirect taxes and by raising the rate of interest.

The measures for controlling inflation can be divided into three broad categories:

- **Monetary measures:** The central bank of the country (RBI in case of India) can curb inflation by restricting the supply of money and credit with the help of three important measures available to it. These include:
  - Bank rate policy,
  - Open market operations, and
  - Varying the reserve requirements of the member banks.

Monetary policy and decisions in India are taken by the **'Monetary policy Committee (MPC)'.**

Monetary Policy Committee

- **About:** It is a body created in 2016, and is responsible for fixing the benchmark interest rate in the country.
  - Its meetings are held at least four times a year (specifically, at least once a quarter) and it publishes its decisions after each such meeting.
  - The committee is answerable to the government of India if the inflation exceeds the range prescribed for three consecutive quarters.
- **First proposed by:** The Urjit Patel Committee.
- **Members:** The committee comprises six members – **three officials** of the Reserve Bank of India and **three external members** nominated by the government of India.
  - They need to observe a "silent period" of seven days before and after the rate decision for "utmost confidentiality".
  - The governor of the Reserve Bank of India is the chairperson ex-officio of the committee.
- **Decision(s):** It is taken by majority with the governor having the casting vote in case of a tie.
- **The current mandate:** To maintain 4% annual inflation until 31 March 2026 with an upper tolerance of 6% and a lower tolerance of 2%.

- **Fiscal measures:** Fiscal measures refer to taxation, government spending, and public borrowings.
  - Governments try to mop up, through taxation, as much purchasing power as possible without adverse effects in incentives to enterprises and investment.
  - A decrease in government spending and an increase in the government's total tax revenue i.e., producing a surplus budget is an important fiscal measure that can successfully check inflationary pressures in the economy.
- **Administrative and other measures:**

  It includes:
  - Prevention of black marketing and prevention of hoarding.
  - Banning the export of constrained materials.
  - Suspending future trading,
  - Facilitating supply of goods and services in case of demand-pull inflation.

Producer Price Index (PPI)

- The Producer Price Index (PPI) measures the average changes over time in the prices **domestic producers** receive for their output. It measures price changes from the perspective of the producer.
- The proposal of switching over to the PPI (from the WPI) came up from the government by mid-2003 (A **working group** was set up in mid-2003–04 **under the chairmanship of Prof. Abhijit Sen**).
- A committee under the Chairmanship of **B. N. Goldar** was created in 2014 which submitted its recommendations in 2017 to advise methodology for introducing PPI in the country. It majorly recommended:
  - Shifting from WPI to PPI on an experimental basis to measure inflation.
  - Using the data from 'supply use tables' to compute experimental PPI.
  - Keeping the Base year for experimental PPI should be 2011-12.
  - Including services price in the PPI basket.
  - Including major export and import items while calculating experimental PPI.
- Many advanced countries like the USA and some emerging countries have switched to using PPI instead of WPI.
- IMF has recommended shifting to PPI instead of measuring WPI.

Housing Price Index

Launched in July 2007, **NHB Residex** is India's official Housing Price Index (HPI). Developed by the **National Housing Bank (NHB)**, the country's home loans regulator, NHB Residex tracks changes in residential property prices across major Indian cities.

Key features of NHB Residex

- **Coverage:** Currently covers 50 cities, including 21 state/UT capitals and 33 Smart cities, with plans to expand to 100 cities.
- **Frequency:** Published quarterly, providing regular updates on housing market trends.
- **Base year:** 2017-18, allowing for year-on-year comparisons of price changes.
- **Focus:** Tracks prices for different property types, including apartments, villas, and builder floors, at various stages of construction (under construction, ready-to-move-in, and resale).

Benefits of NHB Residex

- **Policymakers:** Helps in formulating policies related to housing finance, infrastructure development, and urban planning.
- **Banks and housing finance companies:** Provides insights into housing market risks and helps in determining loan pricing and underwriting decisions.
- **Builders and developers:** Offers valuable data on price trends and consumer preferences, aiding in project planning and marketing strategies.
- **Investors:** Provides information on potential returns from investments in the housing market.
- **Homebuyers:** Helps in making informed decisions about buying or selling property.

Limitations of NHB Residex:

- **Limited coverage:** Currently does not provide a composite all-India HPI, making it difficult to assess national trends.
- **Data collection challenges:** Relies on self-reported data from developers and builders, which may not always be accurate.
- **Regional variations:** Housing market dynamics can vary significantly across different cities, which may not be fully captured by the index.

Despite these limitations, NHB Residex remains a valuable tool for understanding India's housing market and its impact on the broader economy.

Service Price Index:

Over the past decade, India's service sector has muscled its way to dominance, now contributing over 60% to the nation's GDP. However, this meteoric rise has exposed a crucial gap: the lack of a dedicated Service Price Index (SPI).

Currently, India relies solely on the Wholesale Price Index (WPI), which tracks price changes in the commodity-producing sector, encompassing agriculture and manufacturing (primary and secondary sectors). This leaves the dynamic and massive service sector, encompassing everything from finance to healthcare to IT, completely invisible in the inflation picture.

This lack of an SPI throws a wrench in economic analysis and policy making. **Without an accurate gauge of service sector inflation, it's difficult to:**

- **Understand the true inflation picture:** The WPI paints an incomplete picture, potentially masking inflationary pressures in the dominant service sector.
- **Formulate effective economic policies:** Policies aimed at controlling inflation need to consider both goods and services to be effective.
- **Make informed investment decisions:** Investors rely on accurate inflation data to assess risks and returns.
- **Track the service sector's health:** An SPI would provide valuable insights into the performance and growth of this crucial segment of the economy.

IGNITE YOUR MIND

Do you think the implementation of the Producer Price Index (PPI) and the Housing Price Index (HPI) can significantly enhance the accuracy and comprehensiveness of measuring inflation in India? In your opinion, should India prioritize this transition, and if so, what key considerations should guide its implementation?

The absence of an SPI is a pressing concern, hindering our understanding of India's economic landscape. As the service sector continues its ascent, the need for a robust and comprehensive inflation measure becomes ever more urgent.

BUSINESS CYCLE

Growth and development are inextricably linked. To improve an economy's quality of life, deliberate public policy must prioritize investments in critical areas like food, nutrition, health, education, shelter, and social security. However, these expenditures require an equitable distribution of income within the economy.

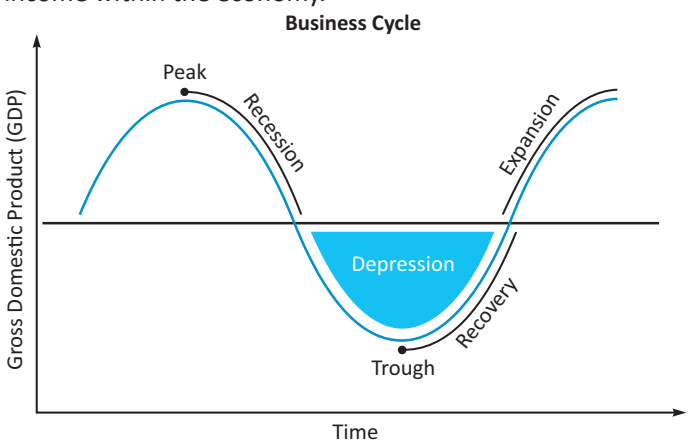


Fig. 6.3: Bussiness Cycle

Income growth, or rising real gross national product (GNP), drives economic prosperity. Therefore, development hinges on increased growth and higher levels of economic activity. Governments constantly tinker with policies to maintain desired levels of economic activity. However, this isn't always successful, leading to recurring boom-and-bust cycles, characteristic of capitalist and market economies.

Boom-and-bust cycles are periods of economic expansion (boom) followed by contraction (bust), studied under the umbrella of business or economic cycles. During a boom, the economy thrives, creating jobs and rapidly expanding income. Conversely, a bust sees economic shrinkage,

resulting in widespread job losses, and dramatic income decline. The duration of these cycles varies, impacted by consumer and investor confidence.

There are many intermediate cycles between a boom and a bust. Following is a brief discussion about four major cycles:

Depression

While the Great Depression of 1929 remains a stark reminder of economic peril, economists have identified key traits to recognize such situations. **These "depression bells" ring loud and clear when:**

- **Demand shrivels:** Aggregate demand, the total desire for goods and services, plummets, causing economic activity to grind to a halt. Businesses struggle, consumers tighten belts, and the whole system stalls.
- **Prices plummet, not soar:** Unlike typical recessions with rising prices, depressions see deflation, where prices fall sharply due to lack of demand. This creates a vicious cycle, as businesses cut prices to attract buyers, further suppressing demand.
- **Jobs vanish like smoke:** Unemployment skyrockets as businesses, desperate to stay afloat, resort to layoffs and cutbacks. This further stifles demand, creating a devastating spiral.
- **Painful cuts become the norm:** To survive, companies slash costs, often through "forced labor cuts" (layoffs) and retrenchment (reduced production). This further deepens the economic crisis.

These symptoms paint a picture of chaos, where even governments struggle to regain control. The Great Depression, in fact, paved the way for Keynesian economics, emphasizing strong government intervention through measures like deficit spending and monetary management to stimulate demand and pull the economy out of the mire.

So, what's the answer to depression? The world's hard-learned lesson: prevention is far better than cure. Modern economies constantly monitor vital signs, like unemployment and inflation, to detect early warning signals of depression. By acting swiftly with targeted policies, they aim to prevent the descent into that dark abyss and keep their economies on a healthy path.

Recovery

An economy stuck in a ditch of low production. Whether it's a deep depression, a milder recession, or a simple slowdown, the goal is always the same: climb back out. That's where governments come in, armed with tools to boost demand and production, ultimately steering the economy toward recovery.

So, How Does an Economy Rise From The Ashes?

- **Demand gets back on its feet:** The total desire for goods and services, known as aggregate demand, starts to pick up. This fuels the engine of production, pushing factories back into gear.
- **Growth sprouts in unexpected places:** As production churns, businesses expand, opening doors for new investments. Suddenly, venturing into uncharted territory seems less risky and more enticing.
- **Prices perk up, but not excessively:** Unlike recessions, where prices usually stay flat, recoveries see a gentle upward climb. This can make borrowing cheaper for businesses, further fueling their expansion.
- **Jobs bloom along the way:** With production humming, companies need more hands on deck. Unemployment eases, replaced by the hope of fresh starts and secure incomes.

These positive ripples eventually reach people's pockets, bringing with them a rise in income. This, in turn, fuels more demand, creating a virtuous cycle of demand and supply, pushing the economy even further up the recovery ladder.

Governments Can Help This Climb Along by Employing Various Tactics

- **Tax breaks for businesses:** Lowering the tax burden encourages companies to invest and hire, revving up the engine of growth.
- **Interest rate cuts:** Making borrowing cheaper for businesses and individuals can entice investments and spending, boosting demand.
- **Public spending increases:** When governments pump money into infrastructure, education, or healthcare, it creates jobs and stimulates the overall economy.
- **Encouraging innovation:** By providing incentives for research and development, governments can spur new ideas and industries, paving the way for long-term economic growth.

History proves this approach works. The Euro-American economies clawed their way out of the Great Depression using similar measures. From India's recovery after the 1997-2002 slowdown to countless other examples worldwide, the message is clear: with the right tools and a bit of time, even the deepest economic slumps can be overcome.

Boom

A boom is a period of rapid and sustained economic growth, where everything seems to be on the rise: production, employment, and yes, even prices. While initially exhilarating, this boom phase can have a dark side, leading to vulnerabilities and eventually, a crash.

Key Traits of a Boom

- **Demand on overdrive:** Consumer and business spending skyrocket, pushing demand for goods and services far beyond what the economy can realistically produce.

Think of it like a queue at a popular restaurant suddenly doubling in size – the kitchen just can't keep up.

- **Supply struggles to catch up:** Businesses scramble to increase production, but raw materials, labor, and infrastructure might not be readily available. This creates a demand-supply gap, where demand outpaces supply, leading to cost-push inflation.
- **Inflationary pressures:** With demand exceeding supply, businesses can raise prices without losing customers. This upward spiral of inflation can erode the purchasing power of consumers and eat away at profits.
- **Market imbalances:** The mismatch between demand and supply disrupts the smooth functioning of the market. This can lead to asset bubbles, where prices of things like stocks and real estate become inflated and disconnected from their underlying value.
- **Underlying cracks:** The boom's fast pace can mask deeper structural problems in the economy. Shortage of investments, low savings rates, and declining living standards can lurk beneath the surface, waiting to be exposed by the inevitable bust.

Boom vs. Recovery: It's important to remember that while both recovery and boom signify economic growth, they differ in their intensity and sustainability. Recovery is like a gentle spring breeze, bringing back life and vitality. Boom is more like a hurricane, powerful and exhilarating, but potentially destructive if not managed carefully.

The Dark Side of Boom: The unsustainability of boom economies is what makes them dangerous. The rapid price increases can lead to interest rate hikes, which in turn can strangle economic activity. Asset bubbles can burst, causing financial crises and widespread losses. And the structural problems left unaddressed during the boom can become magnified in the bust that follows.

Recession

While not as catastrophic as a full-blown depression, a recession can be considered its milder cousin. If unaddressed swiftly and effectively, it can spiral into a more dire situation. The recent financial crisis triggered by the US subprime debacle serves as a stark reminder of this potential.

Recession bears many similarities to depression, as evidenced by the following key traits:

- **Demand Dives:** The lifeblood of any economy is demand. During a recession, consumer and business spending plummet, causing a widespread slowdown in economic activity.
- **Inflation in Limbo:** Unlike the inflationary spirals of boom times, recessions often see subdued or even falling prices. This is because weak demand keeps a lid on prices, even as production costs might remain high.
- **Job Market Woes:** As businesses struggle with declining demand, job losses become commonplace. This translates to rising unemployment rates and widespread hardship.
- **Price Slashing Spree:** In a desperate attempt to attract customers, companies resort to aggressive price cuts. While this might offer temporary relief to consumers, it also highlights the struggle to stay afloat in a slumping market.

Remedies to Counter Recession

Recognizing these early warning signs is crucial for policymakers and businesses alike. By identifying the symptoms of a recession before it takes hold, they can implement measures to mitigate its impact and steer the economy back towards sustainable growth.

Recession throws a wrench in the economic engine, slowing things down and causing hardship. So, what can governments do to get the wheels turning again? Here are some common remedies:

Boosting Demand

- **Tax cuts:** Lowering both direct (income tax) and indirect taxes (customs, excise, sales) puts more money in people's pockets and makes goods cheaper. This extra cash encourages spending, hopefully pulling the economy out of its slump.
- **Wage hikes:** Increasing government salaries and wages injects additional spending power into the economy, stimulating consumption.

Promoting Investment

- **Interest rate cuts:** Making borrowing cheaper encourages businesses to invest and expand, creating jobs and boosting production.
- **Tax breaks and incentives:** Offering special tax benefits for investments in productive sectors like infrastructure or manufacturing attracts much-needed capital and stimulates economic activity.

Making Money Flow

- **Easy money policy:** A more liberal lending environment with lower interest rates makes it easier for businesses and individuals to get loans, further fueling investment and spending.
- Each situation is unique, and the appropriate mix of these measures will depend on the specific circumstances of the recession. However, by taking swift and targeted action, governments can play a crucial role in helping economies recover and get back on track.

Growth Recession

A growth recession is when the economy experiences an extended period (often more than just one quarter) of below-trend real GDP growth and rising unemployment.

Double-Dip Recession

It's a scenario where the economy, after struggling through a recession and finally reaching a brief recovery, suddenly falls back into decline.

Why Does This Happen?

- **Lingering Hangover:** The wounds from the initial recession can take time to heal. Layoffs and spending cuts during the downturn can dampen demand for goods and services, making it hard for the economy to fully recover.
- **Fear and Uncertainty:** The mere threat of a double-dip can be self-fulfilling. Businesses and consumers, worried about another downturn, hold onto their money, further weakening demand and pushing the economy back into recession.
- **Underlying Problems:** Deeper issues like financial imbalances or structural weaknesses in the economy can fester during recovery, creating vulnerabilities that a slight shock can easily exploit.

Therefore, recognizing the early signs of a potential double-dip and taking preemptive measures to shore up the economy is crucial. By addressing underlying issues, building resilience, and fostering confidence, we can prevent the roller coaster from taking another unexpected dive and guide the economy back on a smooth track to steady growth.

IGNITE YOUR MIND

Do you think the role of innovation and technological advancements significantly influences the dynamics of business cycles?

CONCLUSION

Understanding and managing inflation is, therefore not only about stabilizing prices but also about fostering an environment conducive to sustainable economic growth and social well-being. Effective management of inflation requires a balanced approach, combining monetary and fiscal strategies while being mindful of the global economic context.

Money, Banking and Monetary Policy - I

7

INTRODUCTION

In today's economic landscape, money and banking are pivotal elements shaping daily lives and national dynamics. Money facilitates transactions, while banking institutions form the foundation of the financial infrastructure. The chapter explores the historical evolution of currencies and the transformative impact of money on economies. It also examines the crucial role of banking institutions as financial intermediaries, influencing wealth distribution, driving innovation, and contributing to economic resilience or fragility.

EVOLUTION OF MONEY

Money is a multifaceted and abstract concept that transcends its traditional role as a medium of exchange. It encompasses a wide range of forms, functions, and attributes, serving as a societal tool with profound implications for Social, and cultural dynamics.

The evolution of money can be broadly categorized into several stages:

- **Barter System (Pre-Money):** In early human societies, people engaged in barter, exchanging goods and services directly without a standardized medium of exchange. While this system worked on a small scale, it faced **challenges** of **inefficiency, lack of divisibility,** and the **"double coincidence of wants,"** wherein both parties had to want what the other had to offer.
- **Commodity Money:** Recognizing the limitations of barter, societies began to use commodities with intrinsic value as a medium of exchange. Items like salt, cattle, shells, and precious metals such as gold and silver became early forms of money. These commodities were durable, divisible, and had inherent value.

The Barter System

The barter system is an ancient method of exchange where goods and services are directly traded for other goods and services without the use of money as an intermediary. In a barter system, individuals or parties involved in a transaction must have something the other party desires, creating a mutual agreement for the exchange.

- **Metallic Coins:** As trade expanded, the use of precious metals evolved into metallic coins. Governments and rulers started minting standardized coins, ensuring consistency in weight and purity. This provided a more convenient and widely accepted medium of exchange.
- **Representative Money:** To address the challenges of carrying large quantities of metallic coins, representative money emerged. This included promissory notes or certificates that could be exchanged for a specific amount of a commodity (like gold or silver) held in reserve.
- **Paper or Fiat Money:** Over time, governments transitioned from commodity-backed money to fiat money, which is not backed by a physical commodity but derives its value from the trust and confidence of the people. Fiat currencies are declared legal tender by governments and are widely accepted for transactions. In India, two entities issue fiat money – Government of India under the **Coinage act 1909** issues all coins and ₹ 1 note; while RBI Act 1934 empowers RBI to issue the remaining bank notes.
- **Banknotes and Fractional Reserve Banking (FRB):** FRB is a system in which only a fraction of bank deposits are required to be available for withdrawal. Banks only need to keep a specific amount of cash on hand and can create loans from the money you deposit. Fractional reserves work to expand the economy by freeing capital for lending The development of banking institutions introduced the concept of banknotes. Banks issued paper currency representing a claim on a commodity (originally gold or silver). Fractional reserve banking emerged, allowing banks to lend more money than they held in reserves, expanding the money supply.
- **Electronic and Digital Money:** The 20th century saw the rise of electronic money, starting with the use of checks and credit cards. The advent of the internet and advanced technology paved the way for digital currencies and electronic transactions, further reducing the reliance on physical cash. For example **Digital Ruble by Russia, eRupee by RBI**.
- **Cryptocurrencies:** The 21st century witnessed the emergence of cryptocurrencies, led by **Bitcoin**. These decentralized digital currencies use cryptography for security and operate on **blockchain technology**. They represent a new form of money that challenges traditional financial systems.

FUNCTIONS OF MONEY

- **Medium of Exchange:** Money functions as a universally accepted medium through which individuals and entities can facilitate the exchange of goods, services, or assets, promoting efficiency in transactions.

- **Unit of Account:** Money provides a standardized unit of measurement for the valuation of goods, services, and assets, enabling a common language for economic transactions and resource allocation.
- **Store of Value:** As a repository of wealth, money allows individuals to save and store economic value for future use, acting as a durable and transferable asset over time.
- **Standard of Deferred Payment:** Money facilitates agreements for future transactions by serving as a reliable medium for deferred payments and contractual obligations.
- **Symbol of Value and Trust:** Money embodies a symbolic representation of value and trust within a society, reflecting shared beliefs, economic stability, and confidence in the stability of the financial system.
- **Liquidity and Accessibility:** Money is characterized by its high liquidity, ensuring that it can be readily converted into goods, services, or other assets, providing individuals with flexibility and accessibility to resources.
- **Instrument of Economic Policy:** Governments and central banks utilize money as a tool for implementing monetary policies, influencing interest rates, inflation, and overall economic stability.
- **Cultural Symbol:** Beyond its economic functions, money can carry cultural significance, reflecting historical, political, and social aspects of a community. Currency designs and symbols often encapsulate a nation's identity and heritage.
- **Evolutionary Concept:** Money evolves over time, adapting to technological advancements and changes in societal structures. From physical forms like coins and banknotes to digital and virtual currencies, money continually transforms to meet the evolving needs of a dynamic world.

EXCHANGE RATE SYSTEMS

An exchange rate is the rate at which one currency can be exchanged for another. It represents the value of one country's currency in terms of another and is a crucial determinant in international trade and finance. **Exchange rates can be fixed, floating, or a hybrid of both,** and they play a pivotal role in shaping a nation's economic policies and global economic interactions.

For example, **1 US $ = 80Rs or 1 ₹ = 1 Russian Ruble**

Types of Exchange Rate

- **Fixed Exchange Rate System:**
  - In a fixed exchange rate system, the value of a currency is directly tied or pegged to the value of another major currency or a basket of currencies. Governments or central banks actively intervene in the foreign exchange market to maintain the fixed rate by buying or selling their own currency.
  - The fixed exchange rate system **provides stability** and predictability in international trade and investment, but it requires continuous government intervention.
- **Floating Exchange Rate System:**
  - In a floating exchange rate system, the value of a currency is determined by market forces, primarily supply and demand in the foreign exchange market. Central banks or governments do not fix the exchange rate, and the currency value is allowed to fluctuate freely based on market conditions.
  - Floating exchange rates **provide flexibility** and allow for automatic adjustments to external economic shocks, but they can also lead to volatility.
- **Managed Float Exchange Rate System:**
  - This system is a hybrid of fixed and floating exchange rate systems. Currencies are allowed to float i.e to rise and fall to a certain limit, but central banks or governments may intervene occasionally to stabilize or influence their currency's value to not fall excessively.
  - The intervention is usually aimed at preventing excessive volatility or maintaining a specific range for the exchange rate.

Evolution of Exchange Rate System in India

- **Pre-Independence Era (Colonial Period):** During the colonial period, India was under the British Raj, and the exchange rate system was largely influenced by British policies. The Indian rupee was **pegged to the British pound sterling**, maintaining a fixed exchange rate. This fixed regime facilitated trade but also limited India's monetary autonomy.
- **Bretton Woods System (1944-1971):** India participated in the **Bretton Woods Agreement**, and the rupee was pegged to the U.S. dollar. However, this fixed exchange rate system collapsed in 1971 when the U.S. abandoned the gold standard. Subsequently, India shifted to a managed float system, allowing the rupee to fluctuate within a specified range.
- **1975-1991: Controlled Float and Periodic Devaluations:** During this period, India adopted a controlled float system with periodic devaluations. The government intervened to stabilize the exchange rate, adjusting the value of the rupee against a basket of currencies. Devaluations aimed to boost exports and address balance of payments issues.
- **1991 Economic Reforms (Floating exchange rate system):** In the wake of economic reforms in 1991, India shifted towards liberalization, globalization, and privatization. The exchange rate system moved towards a more **market-determined floating exchange rate** system. The government reduced its interference in determining the exchange rate, allowing market forces to play a more significant role. This move contributed to increased export competitiveness and a more sustainable external position.

IGNITE YOUR MIND

Do you think a hybrid exchange rate system, combining elements of fixed and floating systems, provides a balanced approach to managing currency value? How can such a system contribute to stability in international trade while allowing for necessary adjustments to economic shocks?

The evolution of India's exchange rate system reflects the nation's economic trajectory, from a period of limited autonomy during colonial rule to greater flexibility and liberalization in the post-reform era. The current managed float system strikes a balance between market forces and regulatory intervention, contributing to India's position in the global economic landscape.

CRYPTO CURRENCY

Cryptocurrencies are digital or virtual currencies that use cryptography for security and operate on decentralized networks based on blockchain technology. Bitcoin, created in 2009, was the first cryptocurrency, and since then, many others have been developed.

Blockchain & Cryptocurrency

Blockchain is a distributed and **decentralized ledger technology** that allows multiple parties to have a single version of a truth without the need for a central authority. It consists of a chain of blocks, where each block contains a list of transactions.

These blocks are linked together using **cryptographic hashes,** forming a chain. Once a block is added to the chain, it cannot be altered retroactively without altering all subsequent blocks, ensuring the integrity of the entire blockchain.

Cryptocurrency is a digital or virtual form of currency that uses cryptography for security and operates on a decentralized network typically based on blockchain technology. **Bitcoin, created in 2009,** was the first cryptocurrency, and since then, numerous others have been developed. Cryptocurrencies leverage blockchain to gain decentralization, immutability, transparency, and security.

How Does Cryptocurrency Work?

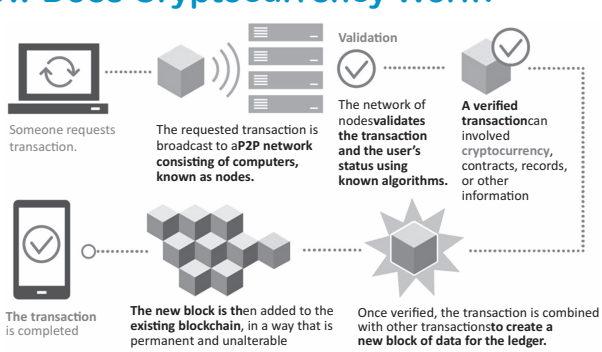

Someone requests transaction.
The requested transaction is broadcast to aP2P network consisting of computers, known as nodes.
Validation
The network of nodesvalidates the transaction and the user's status using known algorithms.
A verified transactioncan involved cryptocurrency, contracts, records, or other information
The transaction is completed
The new block is then added to the existing blockchain, in a way that is permanent and unalterable
Once verified, the transaction is combined with other transactionsto create a new block of data for the ledger.

Fig. 7.1: Mechanism behind Cryptocurrency

Types of Crypto Currency

Cryptocurrencies have evolved into a vast ecosystem with thousands emerging daily. Despite sharing the foundational principles of a decentralized, consensus-based, and immutable ledger for digital value transfer, distinctions among them abound. This overview categorizes cryptocurrencies into four main types:

- **Payment Cryptocurrency:**
  - **Bitcoin**, a trailblazer in this category, exemplifies digital payment cryptocurrencies designed for peer-to-peer electronic cash transactions.
  - These cryptocurrencies have dedicated blockchains solely supporting general-purpose currency functions, excluding smart contracts and decentralized applications (DApps).
  - Notable examples include **Bitcoin, Litecoin, Monero, Dogecoin, and Bitcoin Cash.**
- **Utility Tokens:**
  - Running on existing blockchains, utility tokens, exemplified by Ethereum's Ether, facilitate smart contracts and DApps.
  - Unlike capped payment cryptocurrencies, utility tokens are inflationary, with their value influenced by increasing token creation.
  - Examples include **Ether for transaction fees** on the Ethereum blockchain and tokens like Storj for specific network services.
- **Stablecoins:**
  - Designed for stability, stablecoins maintain value by being pegged to fiat currencies, such as the U.S. dollar or Euro.
  - **Tether (USDT)**, pegged to the U.S. dollar, is a prominent example, relying on reserves to support its value.
  - Stability attracts investors seeking a reliable store of value or a medium of exchange with reduced price volatility.
- **Central Bank Digital Currencies (CBDC):**
  - It is issued by central banks, CBDCs represent official digital currency forms, often pegged to domestic currencies.
  - CBDCs offer efficiency gains and potential cost reductions by leveraging blockchain technology.
  - Government control and monitoring distinguish CBDCs, forfeiting the decentralization and pseudonymity features of other cryptocurrencies.
- **Other tokens:**
  - **Governance Tokens:** Tokens enabling voting in decentralized networks for significant decisions, maintaining decentralization.
  - **Media and Entertainment Tokens:** Used in content, gaming, and online gambling, e.g., Basic Attention Token (BAT) for rewarding users who view ads.
  - **Non-Fungible Tokens (NFTs):** Unique digital assets, distinct from cryptocurrencies, often associated with digital art and collectibles.

Pros and Cons of Cryptocurrency

Pros

- **Decentralization:** Cryptocurrencies operate on a decentralized network of computers, which means they are not controlled by any central authority like a government or financial institution. This reduces the risk of manipulation or interference.
- **Security:** Cryptography ensures the security of transactions, making it difficult for unauthorized parties to alter transaction data or create fraudulent transactions.
- **Lower Transaction Costs:** Traditional financial systems often involve intermediaries like banks, resulting in transaction fees. Cryptocurrencies can significantly reduce these costs as they eliminate the need for intermediaries in many cases.
- **Global Accessibility:** Cryptocurrencies can be accessed and used by anyone with an internet connection, regardless of geographical location. This is particularly beneficial for individuals in regions with limited access to traditional banking systems.
- **Financial Inclusion:** Cryptocurrencies have the potential to provide financial services to individuals who are unbanked or underbanked, giving them access to a global financial system.
- **24/7 Availability:** Cryptocurrency transactions can occur 24/7, unlike traditional banking systems that may have limited operating hours.

Cons

- **Volatility:** Cryptocurrency prices can be highly volatile, leading to significant fluctuations in value over short periods. This volatility can pose risks for investors and make cryptocurrencies less suitable for certain financial applications.
- **Regulatory Uncertainty:** Regulatory frameworks for cryptocurrencies are still evolving in many jurisdictions. Uncertainty about how governments will regulate or tax cryptocurrencies can create challenges for users and businesses in the space.
- **Lack of Consumer Protection:** Unlike traditional bank accounts or credit cards, cryptocurrencies are not insured or protected by regulatory bodies. If a user loses access to their wallet or falls victim to fraud, there may be limited recourse for recovery.
- **Irreversibility of Transactions:** Once a cryptocurrency transaction is confirmed, it is generally irreversible. This lack of a chargeback mechanism can be problematic in cases of accidental transactions or fraud.
- **Limited Acceptance:** While the adoption of cryptocurrencies is growing, they are not universally accepted as a means of payment. Limited acceptance can hinder their practical use for everyday transactions.
- **Technical Complexity:** Using cryptocurrencies involves a learning curve, and understanding concepts like private keys, wallets, and blockchain technology can be challenging for some users.
- **Environmental Concerns:** The energy consumption associated with some cryptocurrency mining operations, especially for proof-of-work-based cryptocurrencies like Bitcoin, has raised environmental concerns due to its carbon footprint.

IGNITE YOUR MIND

As the economy becomes more and more digitised it is leading to new business and employment opportunities, rapid rise of e- commerce and formalisation of the economy. This is fostered by government schemes like Digital India and the prevalence of UPI in urban areas. But urban India is not the whole of India. There are still wide gaps in the outreach of digital financial literacy and technology to the last Indian. Don't you think digitisation of the economy only creates more gaps between classes?

NON FUNGIBLE TOKENS (NFT)

What Is A Non-Fungible Token (NFT)?

A non-fungible token (NFT) serves as a distinct cryptographic asset designed to establish and verify ownership of digital assets. These tokens find application in various domains such as cartoons, music, films, video clips, JPEGs, postcards, sports trading cards, virtual real estate, and pets. NFTs ensure secure documentation by affixing a unique identifying code stored on the blockchain.

Difference Between Fungible and Non-Fungible Assets

Fungibility pertains to the interchangeable nature of assets, where one can be exchanged for another of the same kind with equal value. An example of fungible assets is the US Dollar, where any dollar has an identical value. In contrast, non-fungible assets, like baseball cards, possess unique values based on distinct attributes and scarcity. Each baseball card, distinguished by features such as edition number, design, player, and rarity, has a distinct value, making them non-interchangeable.

Working of NFT's

NFTs rely on blockchain technology to establish ownership, utilizing a decentralized ledger for public authentication. The digital signature within the blockchain verifies ownership and originality. NFT buyers acquire a digital representation of the artwork and a digital certificate of authentication, rather than a tangible piece of art.

Examples and Uses of NFTs

Cryptokitties, launched in November 2017, exemplify a notable use case for NFTs. These digital cats, with unique identifications on Ethereum's blockchain, possess individual values and can "reproduce" with unique attributes. Non-fungible tokens (NFTs) have found applications across various industries, leveraging their unique properties on the blockchain.

- **Digital Art and Collectibles:** NFTs gained early popularity in the art world, allowing digital artists to tokenize their work and establish ownership. This includes digital paintings, illustrations, and other forms of digital art.
- **Gaming:** NFTs are utilized in the gaming industry to represent in-game assets such as characters, skins, weapons, and other virtual items. Players can buy, sell, and trade these assets both within and outside the gaming ecosystem.
- **Music:** Musicians and artists can tokenize their music as NFTs, providing a new way for fans to support and own a piece of their favorite artist's work. NFTs can also grant special access or benefits to token holders.
- **Virtual Real Estate:** NFTs are used to represent ownership of virtual land and properties within decentralized virtual worlds. Users can buy, sell, and trade virtual real estate, and NFTs confer ownership and control over these digital assets.
- **Domain Names:** NFTs can represent ownership of domain names on the blockchain. This provides a decentralized and secure way to transfer and trade domain names.
- **Collectibles and Memorabilia:** Beyond digital art, various digital collectibles and memorabilia, such as virtual trading cards or unique virtual items tied to specific events, can be tokenized as NFTs.
- **Sports:** NFTs are used to tokenize sports-related content, including digital trading cards featuring athletes, memorable sports moments, and virtual merchandise associated with sports teams and events.

Challenges and Risks in NFT Adoption

Complexity

- The technology and tools supporting NFTs and their underlying decentralized applications are still in the early stages, lacking comprehensive tooling to abstract complexities associated with NFT-related solutions.
- **Regulatory/Legal Implications:** The introduction of innovative technologies, especially those involving speculative or high-value assets like NFTs, raises specific regulatory and legal concerns, such as knowing your customer procedures, anti-money laundering mechanisms, and compliance with securities laws.
- **Rapid Innovation:** The swift pace of innovation in the NFT ecosystem and blockchain networks poses challenges for adopters, requiring adaptability and modularity to keep up with consistent changes.

CENTRAL BANK DIGITAL CURRENCY (CBDC)

A CBDC is a digital form of a country's official currency, issued and controlled by its central bank. It's essentially like cash, but in digital form.

There are generally three types of CBDCs: retail, wholesale, and hybrid.

1. Retail CBDCs

These are the most widely acknowledged CBDCs and are intended for general public use. Retail CBDCs are designed to work as a digital currency equivalent, allowing users to make everyday payments and transactions.

Retail CBDCs are available to the general public via digital wallets, smartphone apps, or other payment systems.

2. Wholesale CBDCs

Wholesale CBDCs are intended for use between financial institutions, such as banks, and are not meant for direct access by the general public. They can be used to support high-volume, high-value transactions like interbank transfers and securities settlements.

3. Hybrid CBCDs

Hybrid CBDCs, as the name implies, combine features from both retail and wholesale CBDCs. Hybrid CBDCs are more adaptable than the other two forms as they can be used by both the general public and financial institutions.

Depending on the user's demands, hybrid CBDCs can be used for both everyday transactions and large-value purchases.

It is important to note that the specific design and implementation of CBDCs might vary depending on the central bank issuing them and the demands of the economy.

E-Rupee

E-rupee is a digital form of legal tender issued by the Reserve Bank of India (RBI) that can be exchanged with traditional fiat currency.

- It is a claim on the central bank that can be transferred electronically.
- The RBI divides E-rupee into two types: **Retail E-rupee** for general use and **Wholesale CBDC** for select financial institutions.
- E-rupee could improve the efficiency and security of financial transactions, especially in government securities and interbank markets.
- E-rupee will be issued and distributed by banks through digital wallets on mobile devices.
- E-rupee has benefits such as reducing dollar dependency, lowering currency maintenance costs, ensuring stability, and facilitating global payments.
- E-rupee also faces challenges such as privacy and security risks, digital divide, financial illiteracy, and low acceptability in a cash-based economy.

Difference Between Crypto-Currencies and Digital currencies

Crypto-Currencies	Digital Currencies
Cryptocurrencies are decentralized, and regulations are community-governed.	Digital currencies are centralized, with regulation in a central location, such as a bank.
Cryptocurrencies provide transparency, with all transactions visible on the public blockchain.	Digital currencies lack transparency, keeping wallet addresses and transfers strictly confidential.
Cryptocurrencies are regulated by their respective communities.	Most countries have legal frameworks for digital currencies. Digital currencies have a central authority capable of addressing issues, including freezing or canceling transactions upon request.
Cryptocurrencies operate as an encrypted form of digital currency.	Digital currencies function as a unified electronic cash form.

MONEY SUPPLY

Money supply, also known as the money stock, refers to the total amount of money in circulation within an economy at a specific point in time.

It encompasses various **forms of currency (notes and coins)**, time and demand deposits of businesses, and the government with the banks. Money supply is a key indicator for understanding the overall health of an economy and is crucial for the formulation of monetary policies.

Central banks, such as the Reserve Bank of India (RBI), play a central role in overseeing and controlling the money supply through various monetary policy tools. Exclusively authorized by the RBI, all currency notes and coins are introduced into circulation. The total money supply, encompassing both cash and deposits, is categorized into different measures.

- **Reserve Money (M0):** It is also known as High-Powered Money, monetary base, base money etc.
  - M0 = Currency in Circulation + Bankers' Deposits with RBI + Other deposits with RBI
  - It is the monetary base of the economy.
- **Narrow Money (M1)**
  - M1 = Currency with public + Demand deposits with the Banking system (current account, saving account) + Other deposits with RBI
  - M2 = M1 + Savings deposits of post office savings banks
- **Broad Money (M3)**
  - M3 = M1 + Time deposits with the banking system
  - M4 = M3 + All deposits with post office savings banks (i.e. both demand and time deposits)
- **Currency with the public (CU)** refers to the notes and coins held by individuals, while net demand deposits (DD) represent deposits of the public held by banks, excluding interbank deposits.
- M3, considered the most widely used measure of money supply, excludes interbank deposits and focuses on deposits held by the public. Cash reserves of commercial banks and interbank deposits are not included in the money supply.
- **Liquidity of Money Measure decreases from M1 to M4 whereas the Quantity of Money increases.**

For instance, if a country's money supply amounts to ₹ 10 trillion, distributed across physical currency, demand deposits, and time deposits, the central bank can influence economic activity by adjusting the money supply. To stimulate economic growth, policies may be implemented to increase the money supply, facilitating easier borrowing and promoting spending. Conversely, measures to reduce the money supply may be adopted if inflation is a concern.

The dynamics of money supply have intricate connections to inflation, interest rates, and overall economic stability. **Changes in the money supply influence the purchasing power of individuals,** impact interest rates, and shape investment and consumption patterns. Consequently, central banks vigilantly monitor and adjust the money supply to uphold price stability and foster sustainable economic growth.

Measure		Currency with the Public (CU)	Banking System		Post Office Savings Bank		Liquidity	Quantity
			Demand Deposit	Time Deposits	Demand Deposit	Time Deposit		
Narrow Money	M1	Yes	Yes	No	No	No	↑	↓
	M2	Yes	Yes	No	Yes	No		
Broad Money	M3	Yes	Yes	Yes	No	No		
	M4	Yes	Yes	Yes	Yes	Yes		

MONEY CIRCULATION

Money circulation in an economy refers to the continuous flow and transfer of money as it moves through various economic agents, transactions, and sectors. It is a dynamic process where money changes hands, serving as a medium of exchange for goods, services, and financial assets. The concept of money circulation is fundamental to understanding economic activity, as it reflects the vibrancy and liquidity of a financial system.

Facts about Indian Coins and Currency Notes

The One Rupee note serves as a foundational unit in the currency system and is authenticated by the **Finance Secretary,** affirming its significance. Minted/printed by the Government of India, both coins and the One Rupee note are considered liabilities of the Government. In the circulation process, the Reserve Bank of India (RBI) acquires these one rupee notes and minted coins from the Government of India, classifying them as assets on the RBI's balance sheet.

While all banknotes (excluding the one rupee note) issued by the RBI are supported by assets like gold, Government Securities, and Foreign Currency Assets, denoted in Section 33 of the **RBI Act, 1934,** the phrase ***"I promise to pay the bearer the sum of Rupees…"*** signifies the RBI's commitment to the holder. This obligation is reinforced by the Government of India

MONEY CREATION

The credit creation process stands out as a crucial function performed by commercial banks. While the central bank is tasked with overseeing the money supply in the economy through currency circulation, the execution of this process requires collaboration with commercial banks and their reserves. **Commercial banks, in turn, take on the role of credit creation within the economy.** Hence, the money generated by commercial banks is commonly referred to as credit money. This is achieved through actions such as purchasing securities and extending loans. Commercial banks facilitate this credit creation by utilizing the deposits they receive from the public.

Currency Deposit Ratio (CDR)

The Currency Deposit Ratio (CDR) is the proportion of funds held by the public in the form of currency compared to their holdings in bank deposits **(CDR = Currency in Circulation / Demand Deposits).** It reflects individuals' preferences for liquidity and is a behavioral parameter influenced, in part, by the seasonal spending patterns. For instance, during festive seasons, the CDR tends to rise as individuals convert a portion of their bank deposits into cash to meet additional expenses.

Reserve Deposit Ratio (RDR)

The Reserve Deposit Ratio (RDR) signifies the percentage of total deposits that commercial banks retain as reserves. Reserve money comprises **vault cash in banks and deposits of commercial banks with the Reserve Bank of India (RBI).** Banks use a portion of the money held in deposits as reserve and lend out the rest for various investment projects. The reserves serve to meet cash demands

Conditions for Credit Creation	Credit Creation Limitations
❑ **Public Willingness to Deposit:** The public's willingness to deposit money into commercial banks is crucial for credit creation. ❑ **Banks' Willingness to Lend:** Commercial banks must be willing to extend credit to individuals or businesses. ❑ **Borrowers' Willingness to Seek Credit:** Individuals or businesses must express a willingness to seek money from commercial banks in the form of credit.	❑ **Cash Holdings:** There is a limit to the cash that banks can hold at any given time. This limit is set by the central bank, which can adjust it by buying or selling securities. ❑ **Cash Reserve Ratio (CRR):** Changes in the CRR, through its increase or decrease, impact the potential for credit creation. A decrease in CRR facilitates more credit creation. ❑ **Borrower Availability:** The existence of borrowers is essential for credit creation. If there are no potential borrowers in the economy, credit creation becomes limited.

Significance of Commercial Banks

Commercial banks engage in the collection of deposits from the public, subsequently deploying these funds towards interest-earning investment ventures. The interest rate extended to depositors is identified as the **'borrowing rate,'** while the rate at which banks allocate their reserves to investors is termed the **'lending rate.'** The disparity between these two rates, known as the 'spread,' represents the profit accruing to the banks. **The significance of commercial banks are:**

- **Financial Intermediation:** Commercial banks act as intermediaries between those who have excess funds (depositors) and those who need funds (borrowers). By facilitating the flow of funds, they enhance the efficiency of capital allocation in the economy.
- **Deposit Mobilization:** One of the primary functions of commercial banks is to mobilize deposits from the public. By offering various deposit products, such as savings accounts, fixed deposits, and current accounts, banks attract funds that can be used for lending and investment activities.

Example of Money Creation

Consider a scenario where a bank receives a deposit of ₹ 1,000 designated as a demand deposit. Assuming a **Cash Reserve Ratio (CRR) of 20%,** the bank holds back ₹ 200 and lends the remaining ₹ 800 to a borrower. Despite the depositor asserting ownership of ₹ 1,000 with the bank, the borrower now also has ₹ 800 in circulation. Consequently, a single bank succeeds in generating a credit of ₹ 800. Expanding this example to encompass the entire banking system yields insightful observations. Suppose the borrower, armed with an ₹ 800 loan from Bank A, decides to deposit this sum in another bank (Bank B). Bank B, adhering to a CRR of 20%, retains ₹ 160 (20% of ₹ 800) a loan of ₹ 640. Hence the same ₹ 1000 created 1800 ₹ savings and 1440 credit

- **Credit Creation:** Commercial banks have the unique ability to create credit through the fractional reserve banking system. They can lend a significant portion of the deposits they receive, thereby stimulating economic activities and contributing to the expansion of businesses and industries.
- **Lending and Investment:** Commercial banks provide loans and credit facilities to individuals, businesses, and governments. This financial support is instrumental in funding various projects, promoting entrepreneurship, and fostering economic growth.
- **Economic Stability:** The stability of the banking sector is crucial for overall economic stability. Governments and regulatory authorities closely monitor and regulate commercial banks to ensure their soundness and prevent financial crises.

VALUE OF MONEY

The concept of the value of money refers to the **purchasing power of a currency**, denoting the quantity of goods or services obtainable with a unit of that currency. When the value of money increases, indicating a higher purchasing power, the general price level tends to decrease, and conversely, when the value diminishes, the general price level rises. This inverse relationship signifies the inherent connection between the value of money and the overall price level.

To illustrate, consider a scenario where, at a particular juncture, ₹ 10 could procure two packets of cookies. However, at another time, due to the erosion of the purchasing power of the currency, the same Rs. 10 might only be sufficient to purchase one packet. Consequently, this shift in value influences the increased cost of a biscuit packet, now priced at ₹ 7.

Demand for Money

The overall demand for money in an economy encompasses both transaction demand and speculative demand, collectively referred to as liquidity preference. The demand for money is intricately influenced by several factors that collectively shape individuals' and entities' preferences for holding cash. These determinants play a pivotal role in understanding the dynamics of money demand within an economy. Some key factors are:

- **Price Level:** The prevailing price level exerts a significant impact on money demand. High-interest rates or elevated price levels tend to diminish the demand for money, while lower rates or price levels stimulate greater demand.
- **Inflation Level:** Inflation levels directly affect the demand for money. In an inflationary environment, people may opt to save rather than spend due to the diminishing purchasing power of money, leading to a reduction in money demand.
- **Real Income (Real GDP):** Real income, representing an individual's or entity's earnings after adjusting for inflation, is a crucial determinant. Changes in real income influence spending patterns, with higher real income often correlating with an increased propensity to spend.
- **Disposable Income:** The disposable income, which denotes the amount of income available after taxes and mandatory expenses, plays a significant role in shaping money demand. Higher disposable income tends to foster a greater inclination toward spending.
- **Interest Rates:** The prevailing interest rates influence the opportunity cost of holding money. Higher interest rates may incentivize individuals to invest rather than hold onto cash, reducing the demand for money.
- **Economic Uncertainty:** Economic uncertainty and instability can impact individuals' preferences regarding holding money. In uncertain times, there may be a heightened demand for money as a precautionary measure.
- **Financial Infrastructure:** The efficiency and accessibility of financial infrastructure, including banking systems and digital payment options, can influence the convenience of holding money. Advanced financial technologies may alter the traditional dynamics of money demand.
- **Government Policies:** Policies related to taxation, monetary, and fiscal measures can significantly affect money demand. Changes in policies that impact disposable income or interest rates can have pronounced effects on individuals' willingness to hold money.

High-Power Money

High-powered money, also known as the monetary base, **constitutes the total liability of the country's monetary authority, the Reserve Bank of India (RBI).** This category encompasses currency (comprising notes and coins in circulation and vault cash of commercial banks) and deposits held by both the Government of India and commercial banks with the RBI.

When a member of the public presents a currency note to the RBI, the RBI is obligated to pay its face value. Similarly,

deposits held by the public, government, or banks are considered liabilities of the RBI, refundable on demand. In principle, these liabilities should be substantiated by assets, primarily consisting of gold and foreign exchange reserves. However, many countries adopt a 'minimum reserve system' in practice. By definition, the money supply is equal to currency plus deposits –

M = CU + DD = (1 + cdr)DD where, cdr = CU/DD.

Assuming the treasury deposit of the government with the RBI is zero, high-powered money includes currency held by the public and reserves of commercial banks, encompassing vault cash and banks' deposits with the RBI.

In India, high-powered money is **generated from two sources**: the RBI and the Government of India. The RBI issues currency notes in various denominations, referred to as **'Reserve Money**.' This includes notes of rupees 2, 5, 10, 20, 50, 100, 200, 500, and 2000. Additionally, the RBI issues one-rupee notes and coins, including smaller denominations, on behalf of the Government of India, constituting around 2 percent of the total high-powered money.

IGNITE YOUR MIND

Do you think the concept of high-powered money adequately reflects the complexities of modern monetary systems, especially with the rise of digital currencies and changes in central bank practices? How might these developments impact the traditional understanding of high-powered money in the future?

Money Multiplier

The money multiplier represents the maximum extent to which broad money can be generated by commercial banks, given a fixed amount of base money and a specific reserve ratio. Its calculation is based on the ratio of the total money supply to the high-powered money stock in an economy, denoted as M (stock of money) and H (stock of high-powered money).

The interplay of the Currency Deposit Ratio (cdr) and Reserve Deposit Ratio (rdr) is pivotal in determining the money multiplier. Expressed mathematically, the money multiplier (M) stands as the reciprocal of the Reserve Requirement (R), formulated as M = 1/R. The Reserve Requirement reflects the proportion of deposits that commercial banks are mandated to retain. The Currency deposit ratio depends on the public behavior and the Reserve Deposit Ratio depends on RBI regulations on CRR and SLR. So, money multiplier can also be defined as:

Money multiplier = (1+cdr)/(cdr+rdr)

Emphasizing its significance, **the money multiplier's value is inherently greater than 1**.

Velocity of Money Circulation

The velocity of money circulation refers to the frequency with which a **unit of money changes hands within a specified time period**. It represents the average number of times money is exchanged between different parties during this duration. Several factors influence the velocity of money:

- **Income Distribution:** The velocity tends to be higher when money is in the hands of individuals with lower income, as they are more likely to spend it promptly.
- **Business Cycle:** Economic cycles impact velocity. During periods of economic growth, there is increased production and higher demand for goods and services, leading to more economic transactions and, consequently, higher velocity.
- **Use of EMI Loans:** If a larger portion of the population utilizes installment loans (EMI) for purchases, it can result in an increase in the velocity of money.
- **Country Development:** Developed countries often exhibit higher velocity due to elevated spending patterns and the public's confidence in government social-security measures.

RBI AND ITS FUNCTIONS

The Reserve Bank of India (RBI) is the central banking institution of India, established on **April 1, 1935,** following the Reserve Bank of India Act, 1934 based on the **recommendation of the Hilton Young Commission Report** (1926). It plays a pivotal role in the country's monetary policy formulation and implementation.

The Reserve Bank's Central Office was first instituted in Kolkata but was relocated to Mumbai permanently in 1937. This is the headquarters where the Governor presides and where policies are crafted. While initially privately owned, the Reserve Bank became fully government-owned after its nationalisation in 1949. The inaugural Governor was Sir **Osborne Smith,** succeeded by **Sir James Braid Taylor** as the second Governor and **C. D. Deshmukh** as the third Governor.

Other acts are: Public Debt Act, 1944/Government Securities Act, 2006.

Government Securities Regulations, 2007.

Banking Regulation Act, 1949.

Foreign Exchange Management Act, 1999.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Chapter II)

Reserve Bank of India Act, 1934

Credit Information Companies (Regulation) Act, 2005

Payment and Settlement Systems Act, 2007

Payment and Settlement Systems Act, 2007 As Amended up to 2019

Payment and Settlement Systems Regulations, 2008 As Amended up to 2022

Structure of RBI

- **Central Board of Directors:** The central board, headed by a Governor, manages the affairs of the RBI. It includes four deputy governors, four directors from local boards, and ten directors nominated by the government. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. The directors are appointed/nominated for a period of four years
- **Local Boards:** The RBI has local boards in four regions representing different geographical areas of the country. These boards advise the central board on regional issues and represent local interests.

Functions of RBI

- **Monetary Policy Formulation and Implementation:**
  - The RBI formulates and implements monetary policies to maintain price stability and ensure adequate flow of credit to support economic growth.
  - It uses tools like repo rates, reverse repo rates, and open market operations to control inflation and manage liquidity in the financial system.
- **Currency Issuance and Management:**
  - The RBI has the sole authority to issue currency notes in the country excluding one rupee coin.
  - It manages the supply of currency and credit in the economy to ensure the stability of the currency.
- **Banker to the Government:**
  - The RBI acts as the government's banker and financial advisor, managing the government's accounts, facilitating the issuance of government securities, and handling the government's banking transactions.
- **Banker's Bank and Lender of Last Resort:**
  - The RBI serves as the banker to other banks, maintaining their banking accounts and providing financial services.
  - It acts as a lender of last resort, providing emergency financial assistance to banks facing liquidity crises.
- **Regulator and Supervisor of the Banking System:**
  - The RBI regulates and supervises the functioning of banks and financial institutions to ensure the stability of the financial system.
  - It issues licences to banks, sets regulations, and monitors compliance.
- **Developmental Functions:**
  - The RBI undertakes various developmental functions to promote a sound financial system, including the establishment of institutions like the National Housing Bank (NHB) and the National Bank for Agriculture and Rural Development (NABARD).
- **Foreign Exchange Management:**
  - The RBI manages the country's foreign exchange reserves and formulates policies to promote external trade and payment.
- **Payment and Settlement Systems:**
  - The RBI oversees and regulates payment and settlement systems in the country to ensure their efficiency, security, and integrity.
- **Financial Inclusion:**
  - The RBI promotes financial inclusion by implementing policies and initiatives to provide banking services to the unbanked and underprivileged sections of society.
- **Data Collection and Research:**
  - The RBI collects and publishes data on various economic indicators and conducts research to contribute to economic policymaking.

RBI's Sources of Income

The methods used by the Reserve Bank of India (RBI) to generate revenue or earn profits include:

- **Purchase and Sale of Government Securities:** The RBI generates income by buying and selling government securities, influencing liquidity in the economy.
- **Monetary Policy Operations:** Through operations like the repo market, the RBI provides short-term loans to banks, earning interest on these transactions.
- **Foreign Exchange Reserves Management:** The RBI makes profits when the value of foreign currencies, gold, and other reserve assets appreciates. Additionally, interventions in the foreign exchange market can result in earnings.
- **Banking Services to the Government:** Serving as a banker to the central and state governments, the RBI charges fees for services such as managing accounts, cash flows, and facilitating the issuance and redemption of government bonds.
- **Seigniorage:** Seigniorage refers to the profit that a government/central bank generates by issuing currency, particularly by minting coins or printing paper money. It represents the difference between the face value of the currency and the cost of producing and distributing it.

After meeting expenses and maintaining reserves, the RBI transfers surplus profits to the government, providing an additional source of revenue for the government.

Relationship Between RBI and The Government of India (Section-7 Directive)

The relationship between the Government of India and the Reserve Bank of India (RBI) is structured to ensure cooperation and coordination while maintaining a degree of independence for the central bank. Some key aspects of their relationship are:

- **Statutory Framework:** The RBI operates within the statutory framework provided by the Reserve Bank of India Act, 1934. This legislation outlines the central bank's functions, powers, and the relationship between

the RBI and the government including appointment of RBI members by the government.

- **Section 7 of the Reserve Bank of India Act:** It says that the Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider it necessary in the public interest." **Section 7(2)** gives the government powers to entrust the running of the RBI to its board of directors.
- **Autonomy of the Reserve Bank of India:** The RBI operates as the central banking authority in India and is entrusted with the responsibility of formulating and implementing monetary policy. The central bank's autonomy is crucial to maintain price stability and control inflation. While it operates independently, it is not entirely immune from government influence.
- **Monetary Policy Framework:** The government and the RBI collaborate to establish the monetary policy framework for the country. The RBI's primary objective is to maintain price stability while keeping in mind the objective of growth. The government may provide broad policy direction, but the RBI has the authority to make specific decisions related to interest rates, money supply, and other monetary tools.
- **Government's Representation on RBI's Boards:** The government has a role in the functioning of the RBI through its representation on the central bank's boards and committees. The central board of the RBI includes government nominees, including the Finance Secretary.
- **Consultations and Communication:** Regular consultations and communication occur between the government and the RBI to discuss economic conditions, policy priorities, and strategies for addressing challenges. The Finance Ministry and the RBI engage in dialogues to ensure alignment in economic policies.
- **Appointment of the RBI Governor:** The appointment of the RBI Governor is a decision made by the government, specifically by the Prime Minister in consultation with the Finance Minister. The Governor plays a crucial role in the formulation and execution of monetary policy.
- **Coordination on Financial Stability:** The government and the RBI collaborate to maintain financial stability in the country. This involves supervising banks, managing the currency, and ensuring the overall stability of the financial system.

Economic Capital Framework of the RBI

The Economic Capital Framework of the RBI refers to the methodology and guidelines used by the central bank to determine the appropriate level of capital it needs to hold as a buffer against various risks and to maintain financial stability **(under Section 47 of the RBI Act, 1934).**

Economic capital is essentially the capital that the RBI holds to cover potential losses arising from its operations and exposures. As per this provision, the central bank is required to pay the balance of its profits to the central government after making provision for bad and doubtful debts, depreciation in assets, and contributions to staff.

The previous economic capital framework was developed in 2014-15, and was operationalised in 2015-16. The Reserve Bank of India, in consultation with the central government, had constituted a Committee

Bimal Jalan Committee's Recommendations on RBI's Economic Capital Framework

The Bimal Jalan Committee, constituted by the RBI in 2018, reviewed the existing Economic Capital Framework (ECF) and made several recommendations for improvements. Here are some key points to note:

Distinguish Realized Equity and Revaluation Balances: The committee suggested separating realized equity (accumulated profits) from revaluation balances (fluctuations in asset values) within the ECF. This would improve transparency and better reflect the RBI's true financial position.

Modify Capital Adequacy Ratio (CAR) Range: The committee recommended adjusting the current target range for total economic capital (20.8% - 25.4%) to a narrower range of 20% - 24.5%. This would provide the RBI with sufficient capital while allowing for greater flexibility in managing its operations.

Reduce Contingency Risk Buffer (CRB): The committee suggested lowering the CRB (currently 5.5% - 6.5%) to a range of 4.5% - 5.5%. This would free up more capital for the RBI to fulfill its objectives, while still maintaining adequate buffers against unexpected risks.

Enhance Transparency and Reporting: The committee recommended enhanced disclosure and reporting on the ECF, including clear explanations of risk assessments, methodologies used, and rationale behind capital adequacy decisions.

Shadow Banking

- Imagine a parallel universe within the world of finance, where institutions offer credit and financial services, but operate under looser regulations than traditional banks. That's the realm of shadow banking, a complex system with significant implications for the financial landscape.

What is it?

- Shadow banking encompasses financial entities and activities that mimic regular banking, but often bypass stricter regulations. While not illegal, these institutions operate in a regulatory twilight zone, with less stringent capital requirements and liquidity checks compared to banks.

Who are the players?

- **Housing Finance Companies (HFCs), Retail-NBFCs,** and Liquid Debt Mutual Funds (LDMFs) are common examples of shadow banks. They provide loans, investments, and other financial services, often catering to specific sectors like housing or SMEs.

The Double-Edged Sword

Shadow banking can fuel economic growth by providing credit to underserved segments and offering innovative financial products. However, its inherent risks raise concerns:

- **Leverage:** Shadow banks often operate with high debt levels, making them vulnerable to financial shocks and potentially triggering domino effects within the system.
- **Illiquidity:** Their assets can be difficult to sell quickly, causing liquidity issues if investors panic and demand their money back.
- **Bank Runs:** The lack of explicit deposit insurance, similar to bank guarantees, can make shadow banks susceptible to "bank runs", where investors rush to withdraw funds fearing insolvency.

Regulatory Spotlight

- Recognizing these risks, regulators worldwide are tightening their grip on the shadow banking system. Increased capital requirements, liquidity regulations, and closer supervision are intended to mitigate potential turmoil and maintain financial stability.

Way Forward

- The evolution of shadow banking necessitates careful monitoring and balanced regulation. Striking a chord between fostering innovation and maintaining financial stability is crucial. A well-regulated shadow banking system can complement traditional banks, but overstepping regulatory boundaries can pose significant risks to the entire financial ecosystem.

MONETARY POLICY

Monetary policy is a strategy by the central bank to control money supply and interest rates. It helps achieve economic goals like inflation, growth, and liquidity. In India, the Reserve Bank of India (RBI) is in charge of monetary policy as per the RBI Act, 1934. The RBI uses tools like open market operations, bank rate, reserve system, credit control, and moral persuasion. These tools affect interest rates and money supply, and shape the economy. The monetary policy of India has changed a lot with the new MPF, MPC, and MPP.

Difference between Fiscal Policy and Monetary Policy

Aspect	Fiscal Policy	Monetary Policy
Definition	Government's use of taxation and public spending to influence the economy.	Central bank's management of money supply, interest rates, and credit to influence economic activity.
Authority	Formulated and executed by the government, particularly the finance ministry and legislative bodies.	Implemented by the central bank, independent of the government.
Tools	Primarily uses government spending, taxation, subsidies, and transfer payments.	Primarily uses interest rates, open market operations, and reserve requirements.
Impact on Demand	Directly influences aggregate demand by altering government spending and household incomes through tax changes.	Influences aggregate demand indirectly by affecting interest rates, which influence consumption and investment decisions.
Timing	Often involves longer implementation periods, and its effects may take time to materialize.	Can be implemented relatively quickly, and its impact on the economy is usually more immediate.
Instruments	Government expenditure, taxation, subsidies, transfer payments.	Policy rate (interest rate), open market operations, reserve requirements.
Flexibility	May be less flexible due to the political process required for changes in taxation or spending.	Generally more flexible, allowing central banks to make quicker adjustments.
Scope	Influences the overall fiscal health of the government and can impact income distribution.	Primarily focuses on controlling money supply and interest rates to achieve macroeconomic stability.

Evolution of Monetary Policy in India

Seven Ages of Evolution of Monetary Policy as given by Shri Shaktikanta Das, Governor, Reserve Bank of India

1935 to 1949: Initial Phase

- The inception of the Reserve Bank against the backdrop of the global economic turmoil of the Great Depression in 1930.
- The evolution of the monetary policy framework was guided by the Preamble to the RBI Act, 1934, emphasizing maintaining sterling parity.
- Monetary policy relied on open market operations (OMOs) and alongside utilizing instruments such as the bank rate and cash reserve ratio (CRR) to regulate liquidity.
- The unsettled international monetary system limited policy options.

Fig. 7.2: Evolution of Monetary Policy Committee

1949 to 1969: Monetary Policy Aligned with Five-Year Plans

- Following independence in 1949, monetary policy aligned with the goals of India's Five-Year Plans, prioritizing economic growth and development.
- Monetary policy during this phase used instruments such as the bank rate, reserve requirements, and OMOs to regulate credit availability.
  - Statutory liquidity ratio (SLR) emerged as an additional instrument, influencing government borrowings
- Directed credit allocation targeted key sectors like agriculture and industry.
- Focus on price stability remained secondary.

1969 to 1985: Credit Planning

- The nationalization of major banks in 1969 marked a new phase, aiming to ensure broader credit availability.
- Formal credit planning mechanisms were introduced to channel funds towards priority sectors.
- Selective credit control tools like quantitative restrictions and interest rate manipulation were actively used.
- Inflationary pressures emerged due to excessive credit expansion and external shocks, such as wars, droughts, and oil price shocks

1985 to 1998: Monetary Targeting

- Fiscal dominance in the 1980s resulted in automatic monetization of the budget deficit and increased SLR.
- A shift towards controlling money supply and credit aggregates as intermediate targets for inflation.
- The Chakravarty Committee recommended monetary targeting in 1985, focusing on controlling inflation through limiting monetary expansion.
- However, the relationship between money supply and inflation proved unstable in the Indian context.
- Limitations of monetary targeting became evident.

1998 to 2015: Multiple Indicators Approach

- The liberalization of the economy since the early 1990s necessitated a shift in the monetary policy framework.
- Recognizing the limitations of narrow monetary targeting, the RBI adopted a more flexible approach.
- A wider range of indicators like credit, output, inflation, and exchange rates were considered for policy decisions.
- This provided greater flexibility in responding to changing economic conditions.
- From 1998-99 to 2008-09, this approach yielded an improved average domestic growth rate of 6.4% and moderated WPI-based inflation at 5.4%.

2013-2016: Preconditions Set for Inflation Targeting

- Post the global financial crisis of 2008, persistently high inflation and weakening growth raised questions about the credibility of the multiple indicators approach.
- A need for a clearly defined nominal anchor led to the recommendation of inflation as the focal point by the Urjit Patel Committee in 2014
- The RBI formally adopted an inflation targeting framework in 2016, with a target of 4% inflation +/- 2% tolerance band.
- This framework emphasizes price stability as the primary objective of monetary policy.
- The RBI uses a variety of tools, including repo rates and open market operations, to achieve the inflation target.

2016 Onwards: Flexible Inflation Targeting

- The amendment of the RBI Act in May 2016 formalized the adoption of flexible inflation targeting, with a primary objective of maintaining price stability while considering the imperative of growth.
- The Monetary Policy Framework Agreement solidified the commitment between the Government of India and the Reserve Bank, defining the role of the central bank in the realm of monetary policy.

Objectives of India's Monetary Policy

The objectives of the monetary policy highlight the ultimate goals guiding its actions within a given framework. These goals encompass crucial aspects such as price stability, economic growth, and financial stability.

1. Price Stability:

- Maintaining a stable price level is paramount, as it reduces uncertainty for businesses and consumers, promotes long-term investment, and fosters sustainable economic growth.
- The RBI currently follows a flexible inflation targeting framework, aiming for an inflation rate of 4% +/- 2% tolerance band.

2. Economic Growth:

- Monetary policy tools are used to stimulate economic activity and create an environment conducive to job creation and overall prosperity.
- This involves ensuring adequate credit flow to key sectors like agriculture, industry, and infrastructure.

3. Financial Stability:

- Maintaining a sound and stable financial system is crucial for protecting depositors, preventing financial crises, and promoting efficient allocation of resources.
- The RBI uses various instruments like bank supervision, regulations, and liquidity management to ensure the stability of banks and other financial institutions.

4. External Sector Balance:

- Managing the exchange rate and maintaining a balance of payments equilibrium are essential for facilitating international trade and investment, and preventing excessive currency volatility.
- The RBI intervenes in the foreign exchange market when necessary to stabilize the rupee and ensure orderly foreign exchange transactions.

5. Development Objectives:

- Monetary policy can play a role in supporting the government's development goals, such as poverty reduction, financial inclusion, and sustainable development.
- The RBI implements targeted credit schemes and initiatives to promote these goals and ensure inclusive growth.

Classification of Monetary Policy

The response of monetary policy is contingent upon the economic conditions prevailing in the economy. Based on these conditions, monetary policy can be classified into either an expansionary monetary policy or a contractionary monetary policy.

- **Expansionary Monetary Policy**
  - This is commonly referred to as a loose monetary policy.
  - An expansionary policy involves increasing the supply of money and credit with the aim of fostering economic growth.
  - Central banks may implement an expansionary monetary policy to alleviate unemployment and stimulate growth and investment during challenging economic periods.
  - The overarching objective of an expansionary policy is to promote spending and borrowing.
  - This is achieved by reducing interest rates, and making loans more accessible and affordable for borrowers.
  - According to economic theory, a higher availability of money to individuals and businesses at a lower cost will lead to increased purchases of goods and services, thereby stimulating overall economic growth.
- **Contractionary Monetary Policy**
  - Also known as a tight or contractionary monetary policy, this approach is employed to curb inflation resulting from an economy growing too rapidly (overheating).
  - The primary goal is to decrease the money supply, elevate interest rates, and consequently discourage borrowing within the economy.
  - The decline in business investment is a natural consequence, as borrowing becomes less attractive for firms.
  - Moreover, higher interest rates act as a deterrent to consumer borrowing for significant purchases such as houses and cars.
  - The intention behind a contractionary monetary policy is to maintain economic stability by preventing excessive inflation and promoting a more sustainable pace of economic growth.

Monetary Policy Tools

The monetary policy is implemented by the Reserve Bank of India (RBI) employs the following two instruments:

Quantitative Measures

Quantitative measures refer to actions that influence variables affecting the overall money supply in the economy. The instruments under quantitative measures are:

- **Bank Rate:** The rate at which the Reserve Bank is willing to buy or rediscount bills of exchange or other commercial papers.
- **Cash Reserve Ratio (CRR):** The average daily balance a bank must maintain with the Reserve Bank as a percentage of its Net Demand and Time Liabilities (NDTL).

- **Statutory Liquidity Ratio (SLR):** The portion of NDTL that a bank must maintain in safe and liquid assets, such as government securities, cash, and gold.
- **Liquidity Adjustment Facility (LAF):** Comprises overnight and term repo auctions, facilitating temporary liquidity adjustments within the banking system.
- **Repo Rate:** The fixed interest rate at which the Reserve Bank provides overnight liquidity to banks against collateral of government and approved securities.
- **Reverse Repo Rate:** The fixed interest rate at which the Reserve Bank absorbs overnight liquidity from banks against collateral of eligible government securities.
- **Marginal Standing Facility (MSF):** A facility enabling scheduled commercial banks to borrow additional overnight funds from the Reserve Bank as a safety valve against unforeseen liquidity shocks.
- **Corridor:** The corridor for daily movement in the weighted average call money rate, determined by the MSF rate and reverse repo rate.
- **Market Stabilisation Scheme (MSS):** Introduced in 2004, this instrument manages surplus liquidity from substantial capital inflows by selling short-dated government securities and treasury bills.
- **Open Market Operations (OMOs):** Involves the outright purchase and sale of government securities to inject or absorb durable liquidity, respectively.

IGNITE YOUR MIND

Do you think the current monetary policy tools are well-equipped to address emerging challenges in the global economic landscape, such as the impact of digital currencies and increased financial interconnectedness? How might central banks need to adapt their tools to navigate these evolving dynamics?

STATUTORY LIQUIDITY RATIO AND CASH RESERVE RATIO

Statutory Liquidity Ratio

SLR represents the minimum percentage of deposits that a commercial bank must uphold through liquid assets like gold, cash, and other securities. Notably, these deposits are managed by the banks themselves and are not held by the RBI (Reserve Bank of India). As of now (2023), the current SLR in India stands at 18.00%.

Functioning of Statutory Liquidity Ratio: Each bank is required to maintain a specific portion of its Net Demand and Time Liabilities (NDTL) in the form of cash, gold, or other liquid assets by the end of the day. This ratio of liquid assets to demand and time liabilities is termed as the Statutory Liquidity Ratio (SLR). The RBI has the authority to increase this ratio up to 40%. An augmentation in the ratio limits the bank's capacity to infuse money into the economy, aligning with the RBI's role in regulating money flow and ensuring price stability as part of its monetary policies.

Components of Statutory Liquidity Ratio: Under **Sections 24 and 56 of the Banking Regulation Act 1949,** various banking entities in India are mandated to maintain SLR. The key components include:

- **Liquid Assets:** Easily convertible assets like gold, treasury bills, government-approved securities, government bonds, and cash reserves.
- **Net Demand and Time Liabilities (NDTL):** Total public demand and time liabilities held by banks, encompassing demand deposits and time deposits with specific features.

SLR Limits: The SLR has a **maximum limit of 40%**. These limits play a crucial role in controlling bank credit, with adjustments made by the RBI based on economic conditions.

Objectives of Statutory Liquidity Ratio: The objectives of SLR include preventing over-liquidation by banks, ensuring solvency, and regulating bank credit flow during inflation or recession.

Consequences of Non-Maintenance of SLR: In India, failure to maintain SLR as per RBI guidelines results in penalties. Commercial banks, including scheduled commercial banks and cooperative banks, must report their NDTL to the RBI fortnightly. Penalties of 3% annually over the bank rate are imposed for non-compliance, escalating to 5% for defaults on the next working day. These penalties serve to ensure that banks maintain sufficient cash reserves for customer demands.

Cash Reserve Ratio (CRR)

Cash Reserve Ratio (CRR) signifies the portion of a bank's total deposit stipulated by the Reserve Bank of India (RBI) to be held in reserves as liquid cash.

Objectives of Cash Reserve Ratio

The Cash Reserve Ratio serves as a benchmark for determining the base rate, which is the minimum lending rate set by the RBI. This fixed rate ensures transparency in borrowing and lending within the credit market. Additionally, the CRR aims to:

- Ensure a secure portion of the bank's deposit is held with the Central Bank.
- Control inflation by adjusting the CRR during economic highs, restricting excess money available for loans and investments, thus curbing inflation.

Functioning of Cash Reserve Ratio

When the RBI decides to raise the Cash Reserve Ratio, the available funds with banks decrease. This move regulates the surplus flow of money in the economy. Banks are required to maintain a cash balance with the RBI, **not less than 4%** of the total Net Demand and Time Liabilities (NDTL) on a fortnightly basis. NDTL encompasses the total demand and time liabilities, including public deposits, balances with other banks, demand deposits, and time deposits.

Difference between SLR and CRR

Aspect	Statutory Liquidity Ratio (SLR)	Cash Reserve Ratio (CRR)
Mandated by	Banking Regulation Act, 1949	Reserve Bank of India Act, 1934
Nature of Assets	Reserves comprise liquid assets, including cash and gold.	Requires banks to maintain cash reserves with the RBI.
Earning Returns	Banks earn returns on funds parked as SLR.	Banks do not earn returns on funds parked as CRR.
Credit Expansion Control	SLR is utilized to control the bank's leverage for credit expansion.	CRR is employed by the Central Bank to control liquidity in the banking system.
Location of Securities/Reserves	Securities are kept with the banks themselves, maintained as liquid assets.	Cash reserves are maintained by banks with the Reserve Bank of India.

LIQUIDITY ADJUSTMENT FACILITY

The **Liquidity Adjustment Facility (LAF)** is a crucial tool used by central banks, like the Reserve Bank of India (RBI), to manage short-term liquidity in the banking system. It essentially works like a bridge between banks with temporary cash shortages and those with excess funds. Let's break it down for you:

What is The LAF?

The LAF consists of two main instruments:

- **Repo (Repurchase Agreements):** Under repo, banks can borrow funds from the RBI by pledging government securities as collateral. They agree to repurchase these securities at a later date, along with an interest rate (repo rate). This provides banks with immediate liquidity.
- **Reverse Repo:** This allows banks with excess funds to park them with the RBI for a specified period in exchange for an interest rate (reverse repo rate). This helps absorb surplus liquidity in the system and keeps inflation in check.

How does the LAF Work?

- **Daily Auctions:** The RBI conducts daily auctions for both repo and reverse repo operations, allowing banks to participate based on their individual liquidity needs.
- **Interest Rates:** The repo rate and reverse repo rate are key tools for the RBI to regulate money supply and influence overall economic activity. Higher repo rates discourage borrowing from the RBI, while higher reverse repo rates incentivize banks to park their funds with the RBI, thereby tightening liquidity.
- **Flexibility:** The LAF provides banks with flexible options to manage their short-term cash needs, ensuring smooth functioning of the financial system.

Benefits of the LAF

- **Maintains financial stability:** By managing liquidity, the LAF helps prevent both cash shortages and excess liquidity, ensuring the stability of the banking system.
- **Supports economic growth:** Adequate liquidity promotes lending by banks, which fuels investment and economic activity.
- **Controls inflation:** The LAF provides the RBI with tools to manage inflation by adjusting interest rates and influencing money supply.
- **Enhances market confidence:** A stable and predictable LAF system fosters confidence in the banking system and the overall economy.

Long Term Repo Operations (LTRO)

Long Term Repo Operations (LTRO) is a tool used by the Reserve Bank of India (RBI) to lend money to banks for one to three years at the current repo rate, which is the rate at which banks borrow from the RBI.

The purpose of LTRO is to inject liquidity into the banking system and facilitate the transmission of monetary policy actions and credit flow to the economy

Banks can use government securities as collateral to borrow from the RBI under LTRO.

This helps them to get long-term funds at a lower interest rate than the market rate. LTRO also helps to reduce the volatility of short-term

Challenges of the LAF

- **Dependency on government securities:** The effectiveness of the LAF depends on the availability of sufficient government securities in the banking system.
- **Moral hazard:** Easy access to liquidity through repo may discourage banks from managing their own funds efficiently.
- **Impact on interest rates:** Frequent adjustments in repo and reverse repo rates can cause volatility in interest rates across the market.

Difference between Base Rate, MCLR and External Benchmark Rate

Aspect	Base Rate	MCLR (Marginal Cost of Funds Based Lending Rate)	External Benchmark Lending Rate
Definition	Minimum interest rate set by a bank for lending.	Benchmark lending rate based on the marginal cost of funds.	Interest rate linked to an external benchmark (e.g., repo rate, T-Bill rates).
Year of introduction	2010	2016	2019
Calculation Basis	Average cost of funds and operational costs.	Marginal cost of funds, negative carry on CRR, operating costs, and tenor premium.	Determined by adding a spread over an external benchmark rate.
Linkage to Cost of Funds	Linked to the average cost of funds.	Linked to the marginal cost of funds.	Linked to an external benchmark rate specified by the RBI.
Flexibility and Responsiveness	Changes in Base Rate were relatively slow.	More responsive to changes in market interest rates compared to Base Rate.	Aims for faster transmission of policy rates to end-borrowers.
Frequency of Review	Changes were not frequent.	Banks are required to review and publish MCLR every month.	Reviewed at least once in three months.
Objective (RBI's Intent)	Phased out to replace it with a more responsive system (MCLR).	Introduced for better transmission of changes in policy rates to borrowers.	Improve transmission and bring transparency by linking rates to benchmarks.
Discontinuation Status	Phased out by RBI.	Replaced Base Rate.	Currently in use.

Qualitative Measures

Qualitative measures impact credit quality and include:

- **Marginal Requirements:** Commercial banks set a margin, the difference between the market value of security and the loan value, to grant loans. When the central bank aims to restrict the flow of money, it increases the margin requirement, and vice versa for an expansionary credit policy.
- **Selective Credit Control (SCC's):** This instrument selectively influences the flow of credit to specific sectors, either positively by encouraging credit flow to priority sectors or negatively by restricting credit to a particular sector.
- **Moral Suasion:** This technique involves non-binding persuasion by the central bank to encourage commercial banks to comply with monetary policy. It includes meetings, seminars, speeches, and discussions aimed at explaining the economic scenario and persuading banks to adapt to necessary changes. In essence, moral suasion represents an unofficial form of monetary policy that relies on the power of communication.

Priority Sector Lending

Priority Sector Lending (PSL) is a major initiative by the Reserve Bank of India (RBI) aimed at directing a specific portion of commercial bank credit towards certain sectors deemed crucial for the development and social welfare of the Indian economy. These sectors, often facing funding constraints, require dedicated support to ensure inclusive growth and address critical needs.

Key Features of PSL

- **Targeted Sectors:** PSL encompasses various sectors such as agriculture, small and medium-sized enterprises (SMEs), exports, education, housing, renewable energy, healthcare, and social infrastructure.
- **Mandatory Lending Targets:** The RBI sets mandatory PSL targets for banks, typically expressed as a percentage of their Adjusted Net Time and Demand Liabilities (ANDTL). Currently, the PSL target is set at 40% of ANDTL.
- **Sub-Targets:** Within the overall PSL target, the RBI allocates sub-targets for specific sectors based on their relative importance and development goals.
- **Regulatory Incentives:** Banks fulfilling PSL targets benefit from regulatory incentives like lower capital adequacy requirements, priority access to refinance facilities, and exemptions from certain statutory obligations.
- **Monitoring and Compliance:** The RBI closely monitors banks' compliance with PSL targets and takes corrective action in case of deviations.

Benefits of PSL

- **Promotes inclusive growth:** Directing credit towards under-served sectors fosters balanced development and empowers marginalized communities.
- **Supports key industries:** PSL enables access to finance for crucial sectors like agriculture, SMEs, and infrastructure, driving economic growth and job creation.
- **Social well-being:** Funds directed towards education, healthcare, and social infrastructure contribute to improved living standards and quality of life for citizens.

- **Financial stability:** By supporting productive sectors, PSL strengthens the overall financial system through its positive impact on economic growth and risk mitigation.

Challenges of PSL

- **Diversion of funds:** Concerns exist about potential misuse or diversion of funds away from targeted sectors, hampering the intended outcome.
- **Implementation effectiveness:** Effective monitoring and enforcement are crucial to ensure banks achieve the desired allocations within the PSL framework.
- **Impact on bank profitability:** Meeting PSL targets can put pressure on bank profitability, especially for smaller banks, requiring careful monitoring and adjustments in incentives.
- **Over-dependence on specific sectors:** Excessive reliance on certain sectors within PSL may limit credit flow to other important areas.

What Happens if The Target is Not Met?

- If a bank falls short of meeting the prescribed target set by the Priority Sector Lending (PSL) norms, it is obligated to deposit the earmarked amount into the **Rural Infrastructure Development Fund (RIDF), urban infrastructure development fund, SIDBI, MUDRA Ltd, National Housing Bank (NHB).**
  - The RIDF is administered by the National Bank for Agriculture and Rural Development **(NABARD)**, and the specific amount is determined periodically by the apex bank.
- The interest rates on the contributions made by banks to the RIDF are decided periodically by the Reserve Bank of India (RBI).
- Non-achievement of PSL targets affects regulatory approvals
- Banks can co-lend with NBFCs and housing finance companies to meet PSL targets.

Categories of Priority Sector

The categories of priority sector are as follows

1. Agriculture
2. Micro, Small and Medium Enterprises
3. Export Credit
4. Education
5. Housing
6. Social Infrastructure
7. Renewable Energy
8. Food Processing Sector
9. Weaker sections include:

(i)	Small and Marginal Farmers
(ii)	Artisans, village and cottage industries where individual credit limits do not exceed ₹ 1 lakh
(iii)	Beneficiaries under Government Sponsored Schemes such as National Rural Livelihood Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)
(iv)	Scheduled Castes and Scheduled Tribes
(v)	Beneficiaries of Differential Rate of Interest (DRI) scheme
(vi)	Self Help Groups
(vii)	Distressed farmers indebted to non-institutional lenders
(viii)	Distressed persons other than farmers, with loan amount not exceeding ₹ 1 lakh per borrower to prepay their debt to non-institutional lenders
(ix)	Individual women beneficiaries up to ₹ 1 lakh per borrower (For UCBs, existing loans to women will continue to be classified under weaker sections till their maturity/repayment.)
(x)	Persons with disabilities
(xi)	Minority communities may be notified by the Government of India from time to time.

10. Other Categories included under are:

- Loans directly to **individuals or SHG/JLG members** meeting criteria in the Master Direction on Regulatory Framework for Microfinance Loans (dated March 14, 2022).
- Loans up to ₹ 2.00 lakh to **SHG/JLG for non-agricultural or MSME activities**, such as social needs, housing, toilet construction, or SHG-initiated projects.
- Loans (not exceeding ₹ 1.00 lakh per borrower) to **distressed individuals**, excluding distressed farmers indebted to non-institutional lenders, for prepaying debts to non-institutional lenders.
- Loans to State Sponsored **Organizations for Scheduled Castes/Scheduled Tribes**, exclusively for input procurement and marketing of beneficiaries' outputs.
- **Loans (up to ₹ 50 crore) to Start-ups**, meeting the Ministry of Commerce and Industry's definition, engaged in non-agricultural or MSME activities.

MONETARY POLICY COMMITTEE

The Monetary Policy Committee (MPC) is one of the main committees of the RBI and is responsible for setting the monetary policy stance (setting the repo rate).

Composition of The MPC

- **The MPC comprises six members:**
  - The **Governor of the Reserve Bank of India (RBI) serves as the ex-officio Chairperson.**
  - Deputy Governor of the RBI, One officer of the Bank to be nominated by the Central Board.

- Three external members, appointed by the Government of India, with expertise in economics, finance, or other relevant fields.
- Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or casting vote.

A 6 member committee
Minimum number of the members required for meetng - 4
Required to meet at least four times in a year.
Responsible for setting the monetary policy stance
Monetary Policy Committee

Fig. 7.3: Monetary Policy Committee

- The resolution adopted by the MPC is published after the conclusion of every meeting of the MPC in accordance with the provisions of Chapter III F of the Reserve Bank of India Act, 1934.
- Under the amended RBI Act, the MPC is required to meet at least four times in a year.

Functions of the MPC

- The primary function of the MPC is to determine the repo rate, which is the rate at which banks borrow from the RBI. By adjusting the repo rate, the MPC can influence the money supply and credit availability in the economy.
- The MPC also sets an inflation target, which is currently 4% with a +/- 2% tolerance band. The MPC takes necessary actions to achieve this target through adjustments in the repo rate and other monetary policy instruments.
- The MPC assesses the macroeconomic situation in India and reviews the performance of the monetary policy framework periodically.
- On the 14th day, the minutes of the proceedings of the MPC are published which include:
  - the resolution adopted by the MPC
  - the vote of each member on the resolution, ascribed to such member
  - the statement of each member on the resolution adopted.
- Once in every six months, the Reserve Bank is required to publish a document called the Monetary Policy Report to explain:
  - the sources of inflation
  - the forecast of inflation for 6-18 months ahead.

Supporting Points for MPC

- Some economists view the MPC as a successful reform that has effectively achieved its primary objective of maintaining low inflation.
- The adoption of the inflation-targeting regime played a significant role in curbing the rise in prices.
- The MPC demonstrated success in managing demand-pull inflation effectively.
- Maintaining a stable and moderate inflation rate is beneficial for overall economic health.

Counter Arguments Against MPC

- Critics argue that the MPC, by primarily focusing on inflation control, may have neglected considerations for economic growth, contributing to India's economic slowdown.
- Concerns exist regarding the adequacy and quality of data available to MPC members for making informed decisions.
- The implementation of a tight monetary policy, as favored by the MPC, could potentially result in an economic slowdown.
- Critics caution that an expansionary monetary policy approach may carry the risk of triggering hyperinflation.

Inflation Targeting in India

Inflation targeting is a monetary policy framework adopted by central banks to achieve a specific target for the inflation rate. In India, inflation targeting was formally adopted as a monetary policy framework in 2016. Some of the key aspects of inflation targeting in India are:

- **Introduction of Inflation Targeting:**
  - **Year of Adoption:** In February 2015, the Government of India and the Reserve Bank of India (RBI) signed a Monetary Policy Framework Agreement, introducing the concept of inflation targeting.
  - **Formal Adoption:** The framework officially came into effect in April 2016 with an amendment to the Reserve Bank of India Act, 1934.
- **Inflation Target:**
  - **Target Rate:** The RBI's inflation target is set by the Government of India in consultation with the RBI. The target is set for the Consumer price index (combined), which is the main measure of inflation.
  - **Target Horizon:** The target is typically set for the medium term, usually with a horizon of around 4% with a tolerance band of +/- 2 percentage points.
- **Monetary Policy Committee (MPC):**
  - **Formation:** The MPC was constituted to decide the monetary policy actions, including setting the policy interest rate (repo rate), in order to achieve the inflation target.

- **Composition:** The MPC consists of six members, with three members nominated by the Government of India and three members from the RBI. The RBI Governor is the ex-officio chairperson.

- **Policy Rate:**
  - **Repo Rate:** The primary tool for implementing monetary policy is the repo rate. The MPC adjusts the repo rate to achieve the inflation target.
  - **Reverse Repo Rate:** The reverse repo rate is used as a tool to absorb excess liquidity in the financial system.
- **Inflation Targeting Framework:**
  - **Flexibility:** The inflation targeting framework provides some flexibility to the MPC in achieving the inflation target. It allows for deviations from the target under exceptional circumstances.
  - **Communication:** The RBI communicates its inflation forecasts, policy stance, and the rationale behind its decisions through regular monetary policy statements and reports.
- **Review and Accountability:**
  - **Bi-Monthly Reviews:** The MPC conducts bi-monthly meetings to review economic conditions and assess whether the inflation target is being met.
  - **Accountability:** The MPC is accountable for its decisions, and it provides explanations for deviations from the inflation target.
- **Challenges and Criticisms:**
  - **External Shocks:** External factors, such as global oil prices, can pose challenges to achieving the inflation target.
  - **Supply-side Shocks:** Supply-side factors affecting food and fuel prices can lead to short-term deviations from the target.

Transmission of Monetary Policy

The transmission mechanism of monetary policy is the process by which monetary measures influence the dual objectives of fostering growth and maintaining stable inflation. The impact of monetary policy changes on economic activity and the price level occurs through **five primary channels** of monetary transmission:

- **Interest Rate Channel:** The change in the policy rate affects directly money-market interest rates and, indirectly, lending and deposit rates, which are set by banks to their customers. Monetary easing, marked by reduced interest rates, lowers the cost of capital, stimulating aggregate demand through increased business investment and consumption. Conversely, a tightening of monetary policy has the opposite effect, dampening demand and inflation.
- **Exchange Rate Channel:** Lower domestic interest rates can lead to a depreciation of the domestic currency. This has dual effects: enhancing export competitiveness globally and bolstering domestic demand and economic activity. However, it may also directly increase the rupee prices of imported inputs, raising costs for imports such as crude oil.
- **Credit Channel:** An expansionary monetary policy activates the credit channel, resulting in higher deposits and increased credit disbursal by banks. This, in turn, elevates investment and output in the economy. Additionally, changes in interest rates may alter the debt obligations of businesses, potentially strengthening their financial positions and making financial institutions more inclined to lend, thus fostering increased investment spending.
- **Asset Price Channel:** Asset prices and individuals' wealth significantly impact borrowing capacity and spending. Lower interest rates bolster asset prices, encouraging demand for assets like housing and equities. Higher asset prices also enhance the equity (collateral) available for banks to lend against, facilitating borrowing for households and businesses. Increased asset prices contribute to higher wealth, potentially leading to elevated consumption and housing investment.
- **Expectations Channel:** Inflation expectations play a crucial role in the transmission of monetary policy. By establishing an inflation target, the central bank can anchor inflation expectations, reducing uncertainty for economic agents. With a clearer outlook, households and businesses gain confidence in making decisions about saving and investment, as the fear of inflation or deflation is alleviated.

Stances of RBI on Monetary Policy

- **Accommodative Stance:**
  - This means that the RBI is willing to support the economy and growth by providing ample liquidity and keeping the interest rates low. An accommodative stance signals that the RBI will not increase the policy rates unless there is a sharp rise in inflation.
  - The Reserve Bank of India (RBI) has adopted an accommodative stance, in response to the economic challenges posed by the COVID-19 crisis.
- **Neutral Stance:**
  - This means that the RBI is satisfied with the current state of the economy and inflation and does not want to change the monetary policy significantly. A neutral stance implies that the RBI will adjust the policy rates depending on the evolving economic conditions and data.

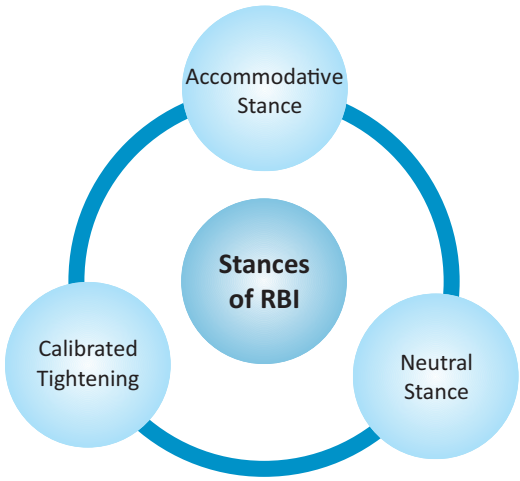


Fig. 7.4: Stances of RBI

- **Hawkish Stance:**
  - This means that the RBI is concerned about high inflation and wants to tighten the monetary policy by increasing the interest rates or reducing the money supply. A hawkish stance aims to curb inflation and cool down the economy.
- **Calibrated Tightening:**
  - Calibrated tightening implies that, within the ongoing rate cycle, a reduction in the repo rate is not considered.
  - However, rate hikes will occur in a measured manner. This suggests that the central bank may not opt for a rate increase in every policy meeting, but the overall policy stance leans towards an eventual rate hike.
  - Such adjustments can occur outside of scheduled policy meetings if the prevailing situation deems it necessary.

Limitations of Monetary Policy in India

- **Constrained Role in Economic Development:** The monetary policy's role in economic development is minor in practice, lacking predominant significance in the developmental process. The Reserve Bank's role is limited to ensuring uninterrupted economic development due to the availability of sufficient funds.
- **Limited Efficacy in Price Control:** The Reserve Bank's monetary policy has played a restricted role in curbing inflationary pressures, failing to achieve the goal of growth with stability.
  - Former Governor I.G. Patel emphasises the need for a comprehensive policy framework, integrating fiscal, foreign exchange, and income policies, which is lacking in India.
- **Unfavourable Banking Practices:** The unfavourable banking habits of the Indian population, preferring cash over cheques, hinder the credit creation capacity of banks.
- **Underdeveloped Money Market:** The money market in India is not well-developed and integrated. The unorganised money market, which consists of informal lenders and borrowers, is not affected by the monetary policy of the central bank.
- **Presence of Black Money:** The money market in India is not well-developed and integrated. The unorganised money market, which consists of informal lenders and borrowers, is not affected by the monetary policy of the central bank.
- **Conflicting Objectives:** Monetary policy faces limitations due to conflicting objectives. While economic development calls for an expansionary policy, price stability requires a contractionary approach. Achieving proper coordination between these objectives proves challenging for monetary policy.
- **Influence of Non-Monetary Factors:** Monetary policy tends to overlook non-monetary factors, limiting its control over inflation originating from real factors, deficit financing, and foreign exchange resources. The Reserve Bank lacks control over deficit financing, impacting money supply.
- **Limitations of Monetary Instruments:** Inherent limitations in credit control instruments, such as inflexibility in bank rates and high margin requirements, impede the effectiveness of monetary policy. Fixed CRR and SLR further constrain funds, hindering the smooth functioning of monetary policy.

IGNITE YOUR MIND

The Monetary Policy Committee is a key body that determines the benchmark policy interest rate in India. Do you think it should have representation from the private sector as well? If so, what is the criteria that should be applied to select the representatives of the private sector?

- **Inadequate Implementation:** The successful application of monetary policy requires timely and appropriately measured restraint or relaxation. However, past experiences reveal Reserve Bank's credit restrictions consistently falling short, reflecting a hesitant approach in the field of monetary control. In summary, the Reserve Bank's monetary policy faces various limitations, necessitating improvements in multiple aspects.

Currency Swap and Forex Swap

Currency Swap and Forex Swap are financial instruments used in the foreign exchange market to manage currency risk, optimise cash flow, and obtain better financing terms.

Currency Swap

A currency swap is a financial contract between two parties to exchange cash flows in different currencies at predetermined exchange rates. These agreements help entities to secure access to a specific currency and manage interest rate exposure.

Structure:

- **Principal Exchange:** The parties exchange principal amounts in different currencies.
- **Interest Payments:** They also exchange interest payments during the swap period.
- **Reexchange:** At the end of the agreement, the parties re-exchange the principal amounts.

Example: Consider Company A in the United States and Company B in the Eurozone. Suppose Company A needs Euros, and Company B needs U.S. Dollars. They enter into a currency swap:

- **Company A borrows $10 million from the U.S., paying interest in dollars.**
- **Company B borrows €8 million from the Eurozone, paying interest in euros.**
- **They exchange these amounts at the prevailing exchange rate.**

At the end of the swap period, they re-exchange the principal. This allows both companies to meet their financing needs in their respective currencies without incurring currency risk.

Forex Swap

A forex swap is a derivative contract where two parties exchange financial instruments (usually cash flows) in different currencies. It involves the simultaneous purchase and sale of the same amount of currency for two different value dates.

Structure

- **Spot Transaction:** Initial exchange of currencies at the spot rate.
- **Forward Transaction:** Agreement to reverse the initial transaction at a future date, with a predetermined exchange rate.

Example: Let's say Company X in the U.S. wants to acquire Japanese Yen for a project in Japan, and Company Y in Japan needs U.S. Dollars. They enter into a forex swap:

- Company X buys ¥100 million for $1 million in the spot market.
- Simultaneously, they agree to reverse the transaction in 90 days at an agreed-upon forward rate.

At the end of the 90-day period, Company X sells ¥100 million back to Company Y for $1 million. The forex swap allows both companies to obtain the needed currencies without exposure to exchange rate fluctuations.

Difference Between Currency Swap and Forex Swap

Key Differences	Currency Swap	Forex Swap
Nature	Involves the exchange of both principal and interest payments.	Involves the exchange of only cash flows, typically with a spot and a forward leg.
Purpose	Primarily used for obtaining needed currency and managing interest rate risk.	Primarily used for hedging or obtaining short-term funding in different currencies.
Components	Involves both a spot and a forward transaction.	Involves a spot transaction followed by a forward transaction.

LIQUIDITY TRAP

A liquidity trap occurs when an economy experiences exceptionally low interest rates, prompting individuals to hold onto cash due to uncertainty about the nation's economic performance. This phenomenon is prevalent during attempts to recover from a recession, where the government aims to stimulate investment by reducing interest rates.

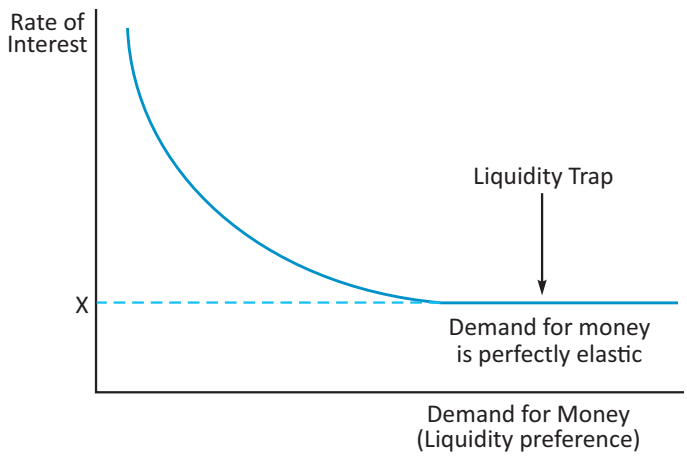


Fig. 7.5: Liquidity Trap

In a typical economy, lowering interest rates encourages borrowing and spending, leading to increased private investments and consumer expenditures, ultimately boosting aggregate demand and GDP. However, in a liquidity trap, further reductions in interest rates have no impact on borrowing patterns. Individuals, anticipating economic weakness, prefer holding onto cash rather than engaging in economic activities.

Concept of Liquidity Trap

The concept of a liquidity trap was introduced by economists J.M. Keynes and J.H. Hicks in 1937, arising post the Great Depression. Despite interest rates near zero, there was

minimal improvement in global borrowing and investment patterns due to economic uncertainty and a pessimistic outlook. Keynes proposed fiscal policies, later integrated into Hicks' IS-LM model, suggesting that massive government expenditure increases the money supply, and aggregate demand and aids recovery from a liquidity trap.

Factors Contributing to a Liquidity Trap

A negative perception regarding investment develops among individuals in an economy post-recession, driven by the expectation of limited gains in the stock market. This pessimistic outlook prompts heightened individual savings as economic conditions are anticipated to worsen. Consequently, the impact of a liquidity trap is constrained, given the inability to further decrease interest rates already close to zero.

Ramifications of a Liquidity Trap

Understanding the implications of a liquidity trap involves examining its effects on stock and bond markets. Investment in equities is significantly hindered as uncertainty prevails about companies' future performance. This diminishes cash flows for businesses, thereby adversely affecting production levels and impacting a country's GDP.

Similarly, investments in the bond market experience a substantial reduction. Bond prices and interest rates share an inverse relationship, leading to a shift to alternative investment avenues like fixed deposits when market interest rates rise. This diminishes demand for bonds, resulting in a sharp decline in bond prices.

During liquidity traps, individuals anticipate eventual rises in interest rates, causing a decline in bond prices. Consequently, fearing capital losses, individuals prefer holding onto cash or maintaining standard savings accounts instead of investing their funds.

As a result, expansionary monetary policies, characterised by lowering interest rates, prove ineffective in stimulating investment levels in a country. Individuals opt to retain their funds, fearing inadequate returns and market uncertainty.

Indicators of a Liquidity Trap

A primary indicator of a liquidity trap is the extended maintenance of persistently low-interest rate levels mandated by a country's central bank. Despite the primary objective of such policies being to ensure robust economic activity, a liquidity trap can emerge if not closely monitored.

Liquidity traps typically manifest during economic recovery phases when governments implement expansionary policies to enhance spending and investment. Paradoxically, this may lead to increased savings if interest rates are kept excessively low for an extended period.

The aftermath of a recession includes escalating levels of unemployment, translating to reduced incomes for consumers. With diminished financial resources, individuals tend to prioritize savings for potential emergency expenses over investing or spending. Consequently, reducing interest rates fails to revive the economy.

Depressed consumer demand perpetuates a consistent decline in an economy's price level. Such trends adversely affect a country's economic growth rate by discouraging producers from increasing output in response to diminished profits. This negative cycle generates adverse consequences for a country's GDP.

Overcoming a Liquidity Trap

To counter a liquidity trap in economics, a prominent approach involves implementing an expansionary fiscal policy. This entails an increase in government spending coupled with reduced taxes, fostering a positive impact on the economy. This initiative encourages production, subsequently elevating employment levels in a country. As a result, with higher disposable income available for spending, a noticeable rise in aggregate demand and increased investment patterns ensues.

A substantial reduction in the price level can further stimulate individual spending patterns, effectively disrupting the cycle of hoarding money prevalent in an ongoing liquidity trap scenario.

Liquidity Trap Examples – Japan

A notable instance of a liquidity trap is observed in the Japanese economy during the 1990s. The country experienced a significant economic slowdown, leading to a drastic decline in standard interest rates. As consumer and global investment confidence waned, a notable decrease in the Nikkei 225 values, Tokyo's benchmark index, was evident. As of 2019, Japan's interest rates are operating at -0.1%.

IGNITE YOUR MIND

Do you think the concept of a liquidity trap is relevant in the contemporary global economic landscape, especially in the context of unconventional monetary policies and the prolonged low-interest-rate environment? How can central banks adapt their strategies to address the challenges posed by potential liquidity traps in the future?

CONCLUSION

India's monetary policy navigates a complex terrain. Balancing growth and price stability necessitates skillful maneuvering of tools like interest rates, amidst challenges like inflation and global anxieties. In its hands rests the baton to orchestrate a harmonious economic symphony for the nation's future.

Money, Banking and Monetary Policy - II

8

HISTORY OF INDIAN BANKING AND REFORMS

Introduction

The banking sector in India stands as a pivotal component of the nation's financial landscape, characterised by a diverse array of institutions catering to various financial needs. It comprises a mix of public, private, cooperative, and specialised banks offering a wide spectrum of services, from traditional banking to technologically advanced digital solutions. Regulated by the Reserve Bank of India (RBI), the sector has witnessed transformative changes over the years, contributing significantly to India's economic growth by facilitating credit, deposits, investments, and fostering financial inclusion across diverse segments of society.

History of Banking Sector in India

- The banking sector in India is a true manifestation of a mixed economy, comprising public sector banks, private banks, and foreign banks.
- At present, India has **12 Public sector banks, 21 Private Sector Banks, 46 Foreign Banks, 43 Regional Rural Banks, 1534 Urban Cooperative Banks and 96,508 Rural Cooperative Banks**.
- Before 1991, the banking sector was highly protected and controlled under the regulations of the RBI.
- In line with the **1991 Liberalisation policy**, Reforms were initiated in the Banking sector as per the recommendations of the **Narasimham committee**.
- These reforms provided much needed growth and stability to the sector.

Development of Banking in India

Timeline of Banking Sector and Associated Reforms

1770	**Bank of Hindustan**	First bank established in India.
1806-43	**Presidency Banks** of Bombay, Bengal, and Madras	These banks acted as **quasi-central banks until RBI** came into existence. All three were merged in 1921 to form **Imperial Bank of India** which became **State Bank of India** in 1955.
1881	Awadh Commercial Bank	First Commercial Bank of India
1894	**Punjab National Bank**	First commercial bank owned by Indians. Lala Lajpat Rai contributed to its establishment
1900-30		Period of Instability among State-associated banks; Need of a central bank was felt.
1926		The Royal Commission on Indian Currency (**Hilton Young commission**) suggested the establishment of a central bank named the 'Reserve Bank of India.
1 April, 1935	**Reserve Bank of India**	Established under **Reserve Bank of India Act, 1934**. First Governor- **Sir Osborne Smith** First Indian Governor- **C.D. Deshmukh** Initially headquartered at Kolkata, later shifted to **Mumbai**.
1949	**Nationalisation of RBI**	Transfer of all shares of the RBI held by Private Investors to the Government of India. It thereby became a fully Government owned entity. RBI Governor became accountable to Parliament and hence, obligated to pay dividends to Government from its profit
1949	**Banking Rules**	**Banking Regulation Act 1949** passed. Provided more supervision powers to the RBI over Banks.
1955	**Nationalisation of SBI**	
1969	**Nationalisation of 14 Private Banks**	In 1980, Six more banks were nationalised.

1990-91	**LPG Policy**	Liberalisation policy deregulated the banking sector and restrictions were eased
1991	**Narasimham Committee I**	Committee on Financial System
1997	**Narasimham Committee II**	Committee on Banking System
2007	**Raghuram Rajan Committee**	
2014	**PJ Nayak Committee**	

Functions of Banks in India

- **Acceptance of Deposits**
  - Banks serve as custodians of public funds by accepting various types of deposits, including savings, current, fixed deposits, and recurring deposits, providing customers with a safe avenue to park their money.
- **Extending Credit Facilities**
  - They offer loans and advances to individuals, businesses, and industries, contributing to economic growth by providing funds for various purposes such as housing, education, agriculture, and entrepreneurship.
- **Payment Services**
  - Banks facilitate the transfer of funds domestically and internationally through various payment mechanisms like cheques, demand drafts, electronic fund transfers (EFT), Real-Time Gross Settlement (RTGS), and National Electronic Funds Transfer (NEFT).
- **Investment and Asset Management**
  - They engage in investments, managing funds on behalf of customers through avenues like government securities, corporate bonds, mutual funds, and other financial instruments.
- **Foreign Exchange Services**
  - Banks play a vital role in facilitating foreign exchange transactions, including offering services related to foreign currency exchange, trade finance, and foreign remittances for both individuals and businesses.
- **Financial Advisory and Ancillary Services**
  - Providing financial advisory services, wealth management, insurance products, and other ancillary services, aiding customers in financial planning, risk mitigation, and investment diversification.

Beyond These Core Functions, Banks In India Also Contribute to

- **Financial Inclusion:** Providing access to basic banking services like savings accounts and remittance facilities, particularly in rural areas.
- **Economic Growth:** Enabling borrowing for businesses and entrepreneurs, driving job creation and overall economic development.
- **Financial Security:** Safeguarding deposits through government guarantees and regulations, promoting trust and stability in the financial system.

Issues in The Banking Sector

- **Poor Asset Quality:** Lack of efficient asset quality review by banks result in Bad loans.
- **Poor Capital Adequacy:** Capital Adequacy Ratio measures how much capital a bank has to meet its obligations. Capital Adequacy is helpful in protecting depositors and promoting stability and efficiency.
- **Unhedged Forex Exposure:** Sharp fluctuations in the forex market can cause significant strain on Indian companies with substantial foreign borrowings, potentially impacting their ability to repay debts to domestic banks.
- **Corporate Governance issues:** Governance issues, including board composition, transparency, and accountability are issues still existing.
- **Employee and Technology:** Public sector banks have yet to fully embrace technology to offer better products and services.
- **Balance Sheet Management:** Many banks have tried to delay setting aside money as provisions and tried to restructure loans off-record. This is even more problematic considering the poor capital adequacy in Indian banks.
- **Not Enough Rural Branches:** Most of the rural branches are running at a loss because of high overheads and prevalence of the barter system in most parts of rural India.
- **Politico- Bureaucratic Hurdles:** Characterised by red-tapism, lengthy delays, lack of initiative, and slow decision making, coupled with political pressures influencing personnel selection and loan approvals, has hindered the efficient functioning of banks.

Measures Taken to Promote Growth in Banking Sector

- **Structural Measures**
  - **Big Banks:** The Narasimham Committee Report (1991), emphasised that India should have three or four large commercial banks, with domestic and international presence, along with foreign banks.
  - **Need for Differentiated Banks:** Though the universal banking model has been widely preferred, there is a need for niche banking to cater to the specific and varied requirements of different customers and borrowers.
  - **Improvement in Systems and Procedures:** Refining the systems and procedures may help banks economise their risk-weighted assets, which will help reduce capital requirements to some extent.

- **Technological Measures**
  - **Advancement in Technology:** The RBI has established the Reserve Bank Innovation Hub (RBIH) in Bengaluru.
    - Its mandate is to promote innovation across the financial sector by leveraging technology and creating an environment which would facilitate and foster innovation.
  - **Blockchain Banking:** Risk management can be more specific and the neo-banks can leverage the technology to further (digital) financial inclusion and finance higher growth of aspirational/new India.
- **Governmental and RBI Measures**
  - **Improving governance and bringing transparency:** Banks Board Bureau providing assistance to Public Sector Banks to restructure their business strategies.
    - Assisting banks with the strategies to deal with issues of bad loans or stressed assets.
  - **Empowering Banks:** The government should tighten the loose ends by allowing them to build diversified loan portfolios, establishing sector-wise regulators, bestowing more powers to deal effectively with wilful defaulters.
  - Priority Sector Lending is a significant responsibility assigned by the RBI to banks, mandating them to allocate a portion of their loans to specific sectors such as agriculture or small-scale industries.
- **Social Measures**
  - **Mitigating Moral Hazard:** Fifth generation banking reforms should focus on the need for higher individual deposit insurance and effective orderly resolution regimes to mitigate moral hazard and systemic risks with least cost to the public exchequer.

IGNITE YOUR MIND

Do you think the recent technological measures, such as the establishment of the Reserve Bank Innovation Hub and advancements in blockchain banking, are sufficient to propel the Indian banking sector into a digitally inclusive and technologically advanced era? How might these initiatives impact financial inclusion and risk management?

Allowing Large Corporations to Open Their Own Banks in India: A Controversial Debate

The Internal Working Group (IWG) of the RBI, in its report of 2020, suggested The possibility of permitting large corporate and industrial entities to act as bank promoters, igniting a discussion on whether corporate houses should have ownership stakes in banks. The issue of permitting large corporations to establish their own banks in India is multifaceted and contentious, with differing viewpoints among policymakers, economists, and experts. Across the globe, numerous nations have chosen to establish robust barriers between banks and big corporations.

Arguments in Favour of Allowing Large Corporations to Open Banks

- **Addressing Capital Shortages:** Currently Indian banks are in need of capital. The government continuously draws funds from taxpayers and supports public sector banks. Therefore, permitting large corporations to enter the banking sector can help meet the capital requirements.
- **Promotes Financial Inclusion:** Allowing large corporations to open banks could lead to more branches in unbanked areas , Innovative Financial products and robust Infrastructural facilities. This will result in better financial services and greater financial inclusion for underserved populations.
- **Enhanced Competition and Effectiveness:** The entry of large corporations into the banking sector can stimulate competition, prompting existing banks to improve their efficiency. They have the resources and expertise to introduce innovative banking products and services, improve technology, and streamline operations, which could benefit customers and the broader economy.
- **Investment and Growth:** Allowing corporations to establish banks may encourage foreign and domestic investment in the banking sector, leading to increased capital inflows and economic growth.
- **Diversification of Banking Services:** Corporations entering the banking sector may specialise in serving specific industry segments or niche markets, providing tailored services that existing banks might not offer.
- **Risk Management:** Large corporations may have sophisticated risk management strategies, which can help banks mitigate financial risks and enhance stability.

Arguments Against Allowing Large Corporations to Open Banks

- **Concentration of Power:** Allowing large corporations to own banks could lead to a concentration of economic and financial power, potentially creating “too big to fail” institutions that pose systemic risks to the economy.
- **Conflict of Interest:** There is concern that corporate-owned banks may prioritise their corporate interests over the public interest, potentially engaging in risky lending practices or favouring affiliated businesses.
- **Regulatory Challenges:** Regulating corporate-owned banks can be more complex and challenging, as conflicts of interest, corporate governance issues, and regulatory compliance become intricate issues to address.

- **Reduced Competition:** Corporate-owned banks may have the resources to dominate the market, reducing competition and limiting consumer choice.
- **Unfair Advantage:** Corporations can use their banking subsidiaries to gain an unfair advantage in financing, potentially disadvantaging smaller businesses.
- **Market Manipulation:** There's a risk that corporate-owned banks may manipulate financial markets or engage in insider trading using sensitive market information
- **Consumer Protection:** Conflicts of interest may harm consumers if they result in biased lending practices or unfair terms.
- **Connected lending:** Corporate-owned banks may allocate credit preferentially to affiliated businesses, potentially stifling uniform access to credit for all. **Ever-greening** of loans is also a part of connected lending as seen in the case of DHFL and YES Bank.
- **Prudential Concerns:** There is a concern that corporations may not have the same commitment to risk management to ensure financial stability as traditional banks, potentially leading to instability in the financial system.

The Reserve Bank of India (RBI) and the government play a crucial role in regulating and supervising the banking sector and deciding whether to permit large corporations to enter the banking industry. The final decision and regulatory framework will depend on the evolving economic and financial landscape and the government's policy choices. For the time being, it would be prudent to prioritise long-awaited banking reforms and reinforce the operational independence of the Reserve Bank of India (RBI).

Connected Lending

Connected lending, also known as Related party lending or Insider lending, refers to a financial practice in which a bank or financial institution provides loans or credit facilities to individuals or entities that have a close relationship or affiliation with the bank's management, board members, major shareholders, or employees.

Structure and Classification of Banks and Financial Intermediaries in India

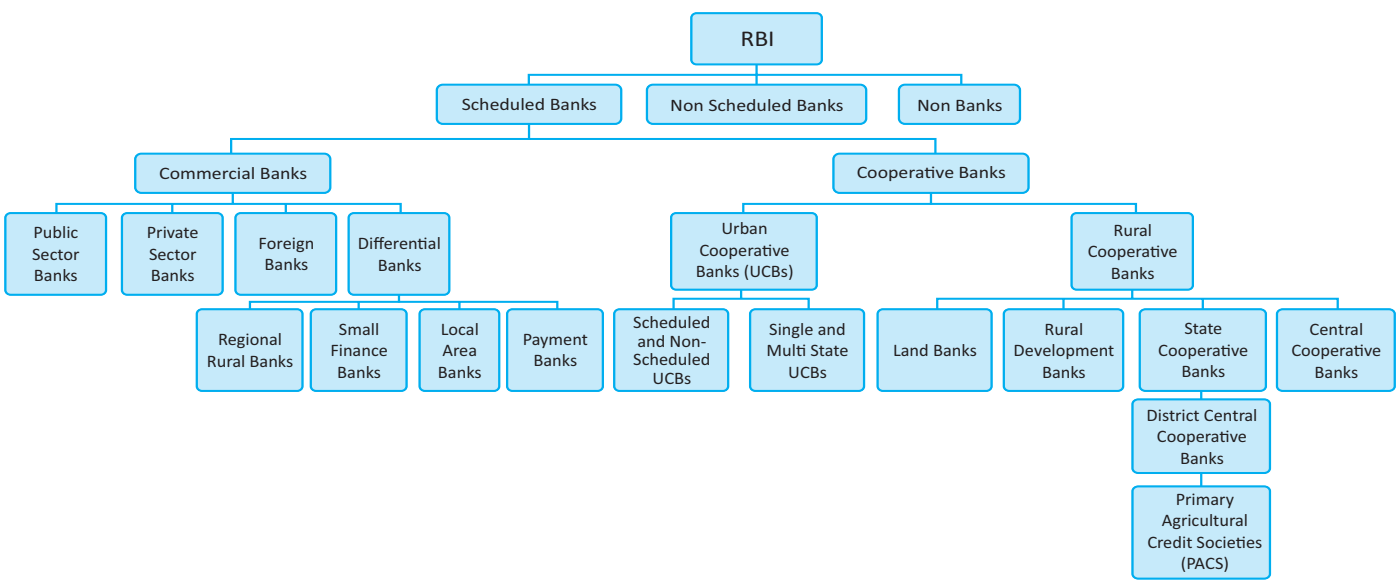


Fig. 8.1: RBI

In India, banks can mainly be divided into:

Commercial Banks

- Commercial Banks can be categorized into two segments: Scheduled Commercial Banks (SCBs) and Non-Scheduled Commercial Banks.
- A Scheduled Commercial Bank (SCB) is officially listed in the Second Schedule of the RBI Act, 1934 and falls under the regulatory framework of the Banking Regulation Act, 1949.
- SCBs have specific advantages, including the ability to seek financial assistance from the RBI at rates like bank rate, repo rate, and Marginal Standing Facility (MSF). However, they have mandatory obligations such as maintaining Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) as stipulated by the RBI.

Two Primary Factors Determine An SCB's Status

- **Financial Stability:** A minimum paid-up capital and reserves of ₹ 5 lakh, ensuring the bank's resilience and ability to manage deposits responsibly.
- **Responsible Conduct:** Maintaining operations that prioritize the welfare of depositors, as determined by the Reserve Bank of India (RBI).

SCBs in India are categorised into five different groups as follows:

1. State Bank of India:
2. Nationalised Banks:
3. Indian Private Banks:
4. Private Sector Foreign Banks:
5. Regional Rural Banks (RRBs):

State Bank of India

- **Formation and Nationalization**
  - Originally known as the 'Imperial Bank of India,' it was established by merging the Banks of Calcutta, Bombay, and Madras in 1921.
  - In 1955, the Imperial Bank of India underwent nationalization and was renamed the State Bank of India (SBI).
- **Expansion and Mergers**
  - By 1960, SBI gained control of seven regional banks from former Indian Princely States, rebranding them as State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Saurashtra, State Bank of Patiala, and State Bank of Travancore.
  - Over time, these entities, along with Bharatiya Mahila Bank, were systematically amalgamated with SBI.
  - State Bank of Saurashtra integrated with SBI in 2008, followed by the merger of State Bank of Indore in 2010.
  - The remaining five associate banks, along with Bharatiya Mahila Bank, merged with SBI in 2017.
- **Present Status and Headquarters**
  - Currently headquartered in Mumbai, the SBI is under the leadership of Chairman Dinesh Kumar Khara.
  - It holds the position of India's largest bank, commanding a 23% market share in assets and around 25% in both loan and deposit markets.
- **Ownership and Nationalisation Status**
  - SBI, although a government-owned financial institution from its inception, isn't categorised among the nationalised banks.
  - The Government of India maintains over a 50% stake in SBI, solidifying its status as a state-owned entity.
- **Banking Crisis and Regulatory Response**
  - The banking crisis from 1913-17, marked by the failure of 588 banks, compelled regulatory intervention for control and regulation.
  - The Banking Companies Act of 1949 laid the foundation for the legal framework governing the banking system, later evolving into the Banking Regulation Act, 1949.
- **Social Control and Nationalisation**
  - Amendments in 1969 under the Banking Regulation Act introduced social control, leading to the nationalisation of 14 banks.
  - These amendments aimed to diversify credit away from being concentrated in large-scale industries and refocus on agriculture, small-scale industries, and exports.
- **Further Nationalisation and Mergers**
  - In 1980, six additional banks with a minimum DTL of 200 crores were nationalised, totaling the nationalised banks to 20.
  - A merger in 1993 between the New Bank of India and Punjab National Bank reduced the count from 20 to 19 nationalised banks.
- **Reasons for Nationalisation**
  - Concentration of economic power in a few hands and private ownership of commercial banks were primary reasons.
  - Banks previously focused on urban areas, neglecting rural and agricultural development, which wasn't a priority sector.
- **Progress After Nationalisation**
  - Branch expansion, particularly in rural areas, was a key outcome.
  - Priority sector lending witnessed a significant rise post-nationalization.
  - Increased levels of deposit mobilisation and bank lending, aiding in entrepreneurial financing schemes.

Recent Developments

The year 2020 witnessed a landmark event in India's banking sector. The mega samalgamation of ten Public Sector Banks (PSBs) into four consolidated entities. This bold move aimed to create stronger, more competitive banks capable of facing global challenges and contributing to India's economic growth.

The Mergers in Focus

- Oriental Bank of Commerce and United Bank of India merged into Punjab National Bank (PNB).
- Syndicate Bank merged into Canara Bank.
- Andhra Bank and Corporation Bank merged into Union Bank of India.
- Allahabad Bank merged into Indian Bank.

Promises of the Mega Merger

- **Global Competitiveness:** Creating larger, more robust banks enables them to compete effectively on a global scale, attracting greater investments and expanding their reach.
- **Cost Synergies and Efficiency:** Mergers often lead to cost advantages through optimised operations, streamlined processes, and larger economies of scale.
- **Enhanced Lending Capacity:** Consolidated PSBs possess higher financial muscle, allowing them to offer larger loans and cater to bigger projects, fueling economic activity.
- **Talent Pool and Database Expansion:** By bringing together diverse skill sets and customer bases, merged banks gain access to a broader talent pool and larger databases, strengthening their market position.
- **Adopting Best Practices:** Merging often creates opportunities to identify and implement best practices across different banks, boosting overall efficiency and risk management.

The Evolving PSB Landscape

Following the amalgamation, India's PSB landscape now comprises 12 entities:

- **11 Nationalised Banks:** These include PNB, Canara Bank, Union Bank of India, Indian Bank, Bank of Baroda, Bank of India, Central Bank of India, UCO Bank, IDBI Bank, PNB Housing Finance, and Vijaya Bank.
- **State Bank of India (SBI):** Remains a separate entity and the largest bank in India.

Beyond 2020: Progress and Challenges

- The merged banks have shown signs of improvement in financial performance, with increased profitability and capital adequacy ratios.
- However, challenges remain in integrating systems, cultures, and processes across different entities.
- Additionally, concerns persist regarding potential job losses and branch closures.

Private Sector Indian Banks

Private Sector Banks are banks where a significant portion of the capital is owned by private shareholders. These banks in India are classified into two categories: Old Private Sector Banks and New Private Sector Banks.

- **Old Private Sector Banks**
  - Banks that remained unaffected by nationalisation in 1969 and 1980 due to their smaller size and regional focus belong to this category.
- **New Private Sector Banks**
  - Banks that emerged post-1991, following economic and financial sector reforms, facilitated by an amendment to the Banking Regulation Act in 1993.
  - This amendment permitted the establishment of New Private Sector Banks in India.
- **Examples of Indian Private Banks**
  - HDFC Bank, Axis Bank, ICICI Bank, Bandhan Bank, Yes Bank, among others, are prominent examples of Private Sector Banks operating in India.

Private Sector Foreign Banks

- **Focus Areas of Foreign Banks**
  - Foreign Banks operating in India typically emphasise trade finance, external commercial borrowings, wholesale lending, investment banking, and treasury services.
- **Examples of Private Sector Foreign Banks**
  - Notable Private Sector Foreign Banks in India include CitiBank, HSBC, Deutsche Bank, American Express, among others. These institutions play a significant role in the financial landscape, offering diverse services to a wide clientele.

IGNITE YOUR MIND

Do you think the differentiation between Old Private Sector Banks and New Private Sector Banks is still relevant in the current banking landscape, considering the evolving economic and financial sector reforms post-1991? How might this classification impact the competitiveness and growth trajectory of Indian private banks

Regional Rural Banks

About Regional Rural Banks

- Regional Rural Banks (RRBs) are specialised banking institutions, established in accordance with the **Regional Rural Banks Act of 1976**, with government sponsorship, to provide rural lending services based on regional needs.
- They bridge the gap between the banking sector and rural areas, ensuring the availability of banking services in remote and underserved regions.
- These banks were initiated in response to the recommendations of the **Narasimham Committee**, aiming to meet the **credit requirements** of rural communities, particularly farmers.
- On October 2, 1975, **Prathama Grameen Bank** became the first rural bank, sponsored by **Syndicate Bank**, a commercial bank.

Operations and Ownership

- The operational area of RRBs is determined by the government of India and generally includes one or more districts within a state.

- These are established through a partnership involving the central government, state government, and sponsoring banks where the equity is held by the stakeholders in a fixed proportion: 50% by the Central Government, 35% by the Sponsor Bank, and 15% by the State Government.
- They mainly serve farmers, small businesses, and rural individuals by offering credit and financial services.

Objectives	Functions
❑ To safeguard customer savings. ❑ To generate credit and boost money supply. ❑ To build trust in the financial system. ❑ To mobilise public savings. ❑ To expand its outreach across all segments of society. ❑ To offer financial services to all income levels. ❑ To promote social equity through inclusive financial services.	❑ Offering banking services in rural and semi-urban regions. ❑ Carrying out operations like disbursement of wages of MGNREGA workers and distribution of pensions. ❑ Offering para-banking services, including lockers, debit/credit cards, mobile banking, internet banking, and UPI.

Issues and Challenges

- **Sustainability Concerns**
  - RRBs struggle with financial sustainability due to **limited business operations** and **high operating costs**.
  - They mainly focus on offering government schemes like direct benefit transfer in rural areas.
- **Inadequate Finance**
  - Adequate capitalization is often a challenge, which hinders their ability to expand and serve a larger customer base effectively.
  - Further, they are dependent on **NABARD** to collect finance for their operation.
  - Low-income rural residents struggle to save due to poverty and limited per capita income, posing challenges for RRBs in collecting adequate deposits.
- **High Overdues and Poor recovery of Loan**
  - Challenges include limited loan access, untrained staff, underutilised credit, production issues, marketing difficulties, and ineffective recovery channels.
- **Regional imbalance:**
  - Branch concentration in certain states and districts results in missed opportunities with potential customers being left behind.
- **Remained Ineffective In Alleviating Poverty**
  - Despite efforts, economic infrastructure gaps, inadequate marketing strategies, limited customer knowledge, low production, and low savings awareness create hurdles for RRBs.
- **Limited Technology Adoption**
  - RRBs lag in the adoption of modern banking technologies which affect their efficiency and competitiveness.

Local Area Banks

Emerging in 1996 as a brainchild of then Finance Minister Dr. Manmohan Singh, Local Area Banks (LABs) carved a unique niche in India's banking system. Unlike their regional counterparts, the Rural Regional Banks (RRBs), LABs operate with a distinct identity:

- Unlike RRBs established by governmsents, LABs are the brainchild of private entities. They came into existence by obtaining a banking licence from the RBI under the Banking Regulation Act, 1949. This allows them to operate as Public Limited Companies registered under the Companies Act, 1956.
- Unlike RRBs with a developmental focus, LABs prioritise profitability. Their primary objective is to generate returns for their shareholders, driving a market-driven approach to their operations.
- Regulations Bind the Path:
- Despite their private origins, LABs operate within the regulatory framework set by the RBI. They comply with norms like Credit Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and Priority Sector Lending requirements, ensuring financial stability and responsible lending practices.
- Local Area Banks primarily focus on specific geographical areas, aiming to cater to the unique financial needs of those communities. They often target:
  - **Underserved Populations:** LABs can reach populations underserved by traditional banks, particularly in rural or remote areas.
  - **Micro and Small Businesses:** Providing loans and financial services to local businesses can fuel economic activity and job creation.
  - **Financial Inclusion:** By offering basic banking services like savings accounts and loans, LABs can promote financial awareness and inclusion within their targeted communities.
- With a relatively young history, the LAB segment continues to evolve. Challenges like limited capital, competition from other financial institutions, and regulatory compliance add complexity to their operations. However, their agility and potential to cater to specific needs hold promise for future growth.

IGNITE YOUR MIND

Do you think the Local Area Banks (LABs) represent a sustainable model for financial inclusion and economic development in specific geographical areas? What challenges might LABs face in achieving profitability while addressing the unique financial needs of underserved populations?

Cooperative Banks

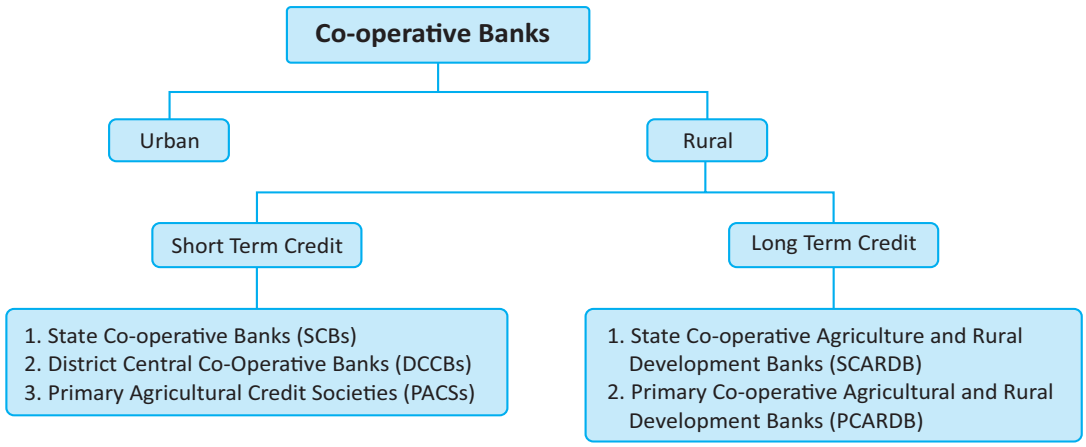

Co-operative Banks
Urban
Rural
Short Term Credit
Long Term Credit
1. State Co-operative Banks (SCBs)
2. District Central Co-Operative Banks (DCCBs)
3. Primary Agricultural Credit Societies (PACSs)
1. State Co-operative Agriculture and Rural Development Banks (SCARDB)
2. Primary Co-operative Agricultural and Rural Development Banks (PCARDB)

Fig. 8.2

- India's bustling landscape of small businesses owes a significant debt to its network of Cooperative Banks. These unique financial institutions, smaller than traditional banks, play a crucial role in empowering entrepreneurs across urban and rural regions.
- Regulated by the Reserve Bank of India (RBI), these banks fall under the purview of the Banking Regulations Act, 1949, and the banking laws act, 1965.
- **Small but Mighty:** Compared to large commercial banks, Cooperative Banks focus on catering to the specific needs of micro and small businesses. Their smaller scale allows for a closer relationship with local borrowers, understanding their challenges and tailoring financial solutions accordingly.
- **Deep Rural Reach:** With a staggering 67% penetration in villages, Cooperative Banks are a lifeline for rural businesses. They account for almost half (46%) of the net funding for these enterprises, supporting vital sectors like processing, housing, warehousing, transport, and dairy farming.

Types of Cooperative Banks

Within the Cooperative Bank system, there are four distinct tiers:

Central Cooperative Banks

- Operate at the district level, providing loans primarily to affiliated primary societies.
- Two types exist:
- **Cooperative Banking Union:** Members are only cooperative societies.
- **Mixed Control Cooperative Bank:** Members can be societies and individuals.
- Loan tenures typically range from 1 to 3 years.

State Cooperative Banks

- Sit at the apex of the cooperative credit structure, operating at the state level.
- Act as a channel for RBI funds to flow down to other cooperative institutions.
- Enjoy preferential loan rates, 1-2% lower than the standard bank rate.

Primary Cooperative Banks

- Serve urban and semi-urban areas, focusing on non-agricultural businesses.
- Receive concessional refinance from RBI and IDBI for specific loans, like housing, benefiting small businesses.

Land Development Banks

- Cater specifically to farmers' needs, offering credit for development purposes.
- **Comprise three tiers:** Primary, State, and Central.
- Recently came under the regulatory purview of the **National Bank for Agricultural and Rural Development (NABARD)** instead of just RBI and state governments.

Significance of Cooperative Banks

- **Financial Inclusion:** They enable access to essential financial services for underserved rural and small business communities.
- **Economic Growth:** They fuel business expansion, job creation, and overall economic development by providing loans and other financial tools.

- **Stability and Trust:** Backed by RBI regulations and a cooperative ethos, they offer a sense of security and trust to their members.

Challenges Faced by Cooperative Banks

- **Lack of Professional Management:** Many cooperative banks grapple with issues related to professional management and governance, often experiencing inefficiencies due to inadequate expertise in modern banking practices.
- **Capital Constraints:** These banks frequently encounter challenges in raising adequate capital to meet the demands for credit and maintain liquidity levels, hindering their ability to expand operations.
- **Weak Risk Management Frameworks:** Inadequate risk management systems and practices within cooperative banks make them susceptible to non-performing assets (NPAs), credit risks, and liquidity crises, impacting their financial stability.
- **Governance and Transparency Issues:** Transparency and accountability concerns in decision-making processes may arise due to political interference, lack of transparency in operations, and issues in board functioning.
- **Technology and Infrastructure Gaps:** Many cooperative banks struggle to adopt modern technological advancements and infrastructure upgrades, affecting their competitiveness and ability to offer efficient services.
- **Regulatory Compliance Challenges:** Meeting regulatory compliance requirements, particularly in alignment with RBI guidelines, can pose significant challenges, impacting their operational flexibility and growth prospects.

Difference Between Commercial Banks and Cooperative Banks

Aspect	Commercial Banks	Cooperative Banks
Ownership	Private shareholders or government	Owned and controlled by members/customers
Legality	Governed under Banking Regulations Act, 1949	Governed by the Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1955.
Operational Focus	Profit-driven	Community and member-focused
Regulation	Regulated by central bank and other authorities	Regulated by central bank and state governments
Service Area	Urban and rural areas	Local regions and communities
Functions	Wide range of banking and financial services	Basic banking services with a focus on community support
Profit Distribution	Dividends to shareholders	May distribute profits to members or invest in community development

Banking Regulation (Amendment) Act, 2020

It amended the Banking Regulation Act, 1949. It aims at protecting depositors, preventing cooperative banks from falling into fraudulent activities. It made certain changes to address the problem of dual regulations

Type of Bank	Regulator
Commercial (SBI, Axis, etc)	RBI
Cooperative (Single State: Rural)	RBI + State Govt's Registrar for Coop
Cooperative (Single State: Urban)	RBI
Cooperative (Multi State)	RBI
Cooperative (PACS)	State Govt's Registrar for Coop

Differential Banking Institutions

- RBI introduced the concept of differentiated banking in 2013 following recommendations from the Nachiket Mor Committee. Differentiated Banks cater to specific customer segments, contrasting with universal banks that provide a comprehensive array of financial products.
- **Basis of Differentiation:** Differentiation in banking may stem from varying capital requirements, the scope of activities, or specific areas of operations that target distinct customer groups or sectors.
- **Purpose and Objectives:** Aim to offer tailor-made and specialized services or unique financial products finely tuned to suit the specific needs of a particular sector or customer segment.
- **Scope of Services:** Differentiated Banks provide a restricted set of services or products compared to universal banks, focusing on specialized services designed for targeted customer segments.
- **Tailored Services for Specific Sectors:** The differentiated banking model allows for more personalized and sector-specific banking solutions, ensuring more targeted and suitable offerings for specific clientele or industries.

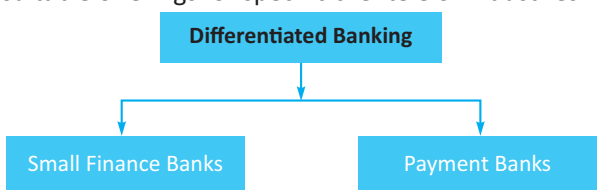


Fig. 8.3: Differentiated Banking

Small Finance Banks

Small Finance Banks (SFBs) have emerged as crucial players in India's financial landscape, catering to the needs of previously underserved segments.

Who are SFBs?

- **Licensed to Serve:** Established as Public Limited Companies, SFBs are licensed by the RBI under the Banking Regulation Act, 1949 and governed by the RBI Act, 1934.
- **Diverse Origins:** Individuals, corporates, trusts, societies, existing NBFCs, Micro Finance Institutions (MFIs), and Local Area Banks (LABs) can all become promoters of SFBs.
- **Continuous Onboarding:** The 'On Tap Facility' introduced in 2019 allows the RBI to accept and grant SFB licenses throughout the year, fostering continuous growth in the sector.

Their Mission

- **Financial Inclusion:** SFBs primarily focus on "basic banking activities", accepting deposits and lending to unserved and underserved sections of society, including: Small business units, Small and marginal farmers, Micro and small industries, Unorganized sector entities
- **RBI's 'On Tap Facility' and Guidelines:**
  - In 2019, the RBI introduced the **'On Tap Facility,'** allowing applications and licensing of SFBs throughout the year.
  - **Priority Sector Focus:** To ensure maximum outreach, 75% of their loans must be directed towards priority sectors like agriculture, small industries, and micro enterprises.
  - **Microloan Champions:** At least 50% of their loans and advances must be below ₹ 25 lakh, catering to smaller borrowers.

Examples of Success

- **Capital Small Finance Bank:** Pioneer SFB established in 2016, demonstrating the sector's potential and impact.
- **Ujjivan Small Finance Bank:** Another successful example, highlighting the reach and diversity of SFBs.

Advantages of SFBs

- **Financial Access:** SFBs are bridging the gap, providing essential financial services like savings accounts, loans, and insurance to previously excluded populations.
- **Economic Empowerment:** By supporting small businesses and farmers, SFBs contribute to job creation, income generation, and overall economic growth.
- **Financial Literacy:** They promote financial awareness and responsible borrowing practices within underserved communities.

Challenges and Opportunities

- **Scaling Up:** Reaching a wider audience and maintaining sustainability while adhering to strict regulations can be challenging.
- **Technology Adoption:** Embracing digital solutions and leveraging data analytics can further enhance efficiency and outreach.
- **Regulatory Framework:** Continuous refinement of regulations is crucial to support SFB growth and ensure the stability of the financial system.

On-tap Licensing: On-tap licensing refers to a regulatory framework or licensing process where entities can apply for licences at any time, rather than waiting for specific licensing windows or periods. In terms of Small Finance Banks, "On-Tap" facility would mean the RBI will accept applications and grant licences to banks throughout the year.

Payment Banks

Payments Banks have emerged as game-changers in India's financial landscape, making essential financial services more accessible to everyone.

Who can be a Payments Bank?

Payments Bank licenses can be granted to:

- **Non-bank entities:** Existing Prepaid Payment Instrument (PPI) issuers or businesses like mobile telephone companies.
- **Financial institutions:** Microfinance Institutions (MFIs) and Small Finance Banks (SFBs) can also establish Payments Banks.

Features of Payment Banks

- **ATM/Debit Cards:** Customers can access their accounts through dedicated or co-branded ATM/Debit cards, facilitating easy withdrawals and payments.
- **Payments and Remittances:** Making payments and money transfers is made smoother with convenient options like mobile banking and digital wallets.
- **Bill Payments:** Paying bills for utilities, phone, and other services can be done directly through the Payments Bank, simplifying financial tasks.
- They do not provide credit services like loans and credit cards.
- PBs provide both current accounts and savings accounts.
- They accept demand deposits but cannot accept time deposits and Non-Resident Indian (NRI) deposits.
- Payment Banks are licensed under Banking Regulation Act, 1949.
- The minimum paid up capital required is ₹ 100 crore and the promoter's stake should remain at least 40% for the first five years.

- FDI is allowed in payment banks.They cannot set up subsidiaries to undertake non-banking activities.
- Additionally, they provide ATM cards or debit cards and offer online or mobile banking services.
- **Note:** Airtel Payments Bank was India's first payment bank .

Regulatory Frameworks

- Though focused on smaller deposits, Payments Banks adhere to similar regulatory frameworks as Commercial Banks, ensuring the safety and security of customer funds.
- This includes maintaining Credit Reserve Ratio (CRR) with the RBI and investing a significant portion of their demand deposit balances in government securities.

Leading Payments Banks include

- **India Post Payments Bank:** Leveraging the vast network of post offices, they reach rural and remote areas.
- **Airtel Payments Bank:** Combining mobile network reach with financial services, they cater to a large customer base.
- **Paytm Payments Bank:** Building on their popular digital wallet platform, they offer convenient banking solutions.

Impacting Lives

Payments Banks make a significant contribution to India's financial landscape:

- **Financial Inclusion:** They bring essential financial services within reach of unbanked and underbanked populations, promoting financial literacy and economic empowerment.
- **Cashless Transactions:** By encouraging digital payments, they contribute to a more efficient and secure financial system.
- **Convenience and Security:** With easy-to-use tools and robust regulations, they offer secure and convenient ways to manage finances.
- **Reaching Remote Areas:** Partnerships with local players and community-based organizations can extend their reach to underserved and excluded populations.

By embracing digital tools, adhering to robust regulations, and focusing on customer needs, Payments Banks can continue to play a crucial role in simplifying financial access and driving inclusive growth in India.

Difference Between Small Finance Banks and Payment Banks

Small Finance Banks	Payment Banks
1. Established on recommendations of Nachiket Mor Committee.	1. Established on recommendations of Nachiket Mor Committee
2. Allowed to take deposits of any amount.	2. Can accept deposits, but only up to ₹ 2 lakh per individual customer.
3. Can extend loans but the focus will be on small lending.	3. Cannot extend loans in any form.
4. Can finance small business, small and marginal farmers,MSME, unorganised sector entities.	4. Can open small savings accounts.
5. Can provide remittances services as well as credit cards.	5. Can provide remittance services.
6. Allowed to issue ATM or debit cards.	6. Allowed to issue ATM /debit cards.
7. PSL - 75% of their overall net credit	7. No PSL requirements as are not allowed to extend loans
8. Has to ensure that 50% of loan portfolio constitutes advances of upto ₹ 25 lakhs.	8. Not allowed to issue credit cards.
9. Can distribute financial products like mutual funds, Insurance, pension etc.	9. Can distribute products like mutual funds, insurance, third party loans.
10. Can accept NRI deposits	10. Payments banks can apply for conversion into small finance banks (SFBs) after five years of operation.
	11. Cannot accept NRI deposits.

IGNITE YOUR MIND

Do you think the concept of on-tap licensing for Small Finance Banks and Payments Banks is a progressive step by the RBI in promoting continuous growth and innovation in the banking sector? How might this approach contribute to a more dynamic and responsive financial ecosystem in India?

Development Financial Institutions (DFIs)

- DFIs are specialized financial entities that cater to the economy's needs by providing long-term financial assistance, especially to sectors crucial for economic growth and infrastructure development. Typically government-owned or established by financial consortia, DFIs have specific mandates focused on facilitating economic development and industrialization.

- **Role and Risk Profile of DFIs**
  - DFIs often take on higher risks compared to traditional lenders like commercial banks, supporting projects considered too risky by conventional sources.
  - Funding sources for DFIs include government capitalization, bonds, equity investment, and multilateral institutions such as the World Bank, rather than accepting deposits.

Prominent DFIs in India's History

- **Industrial Finance Corporation of India (IFCI):** India's first DFI, owned by the Finance Ministry's Department of Financial Services.
- **Industrial Development Bank of India (IDBI) and ICICI:** Played significant roles in providing long-term finance to industries when commercial banks primarily focused on short-term lending.
- **National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI):** Established to promote rural and small-scale industries.
- **EXIM Bank and National Housing Bank (NHB):** EXIM for foreign trade support and NHB for housing finance are other prominent DFIs in India's financial landscape.

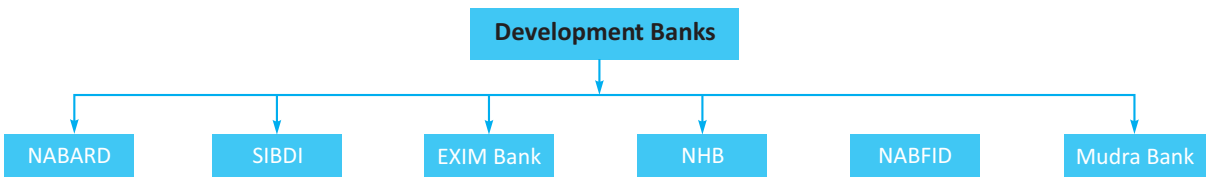


Fig. 8.4: Development Banks

National Bank for Agriculture & Rural Development (NABARD)

- Nestled in Mumbai and with branches across the nation, the National Bank for Agriculture and Rural Development (NABARD) holds the prestigious title of India's apex development bank.
- Born in 1982 following the recommendations of the **B. Sivaraman Committee,** NABARD replaced key institutions like the Agricultural Credit Department and Rural Planning and Credit Cell of RBI, and absorbed the Agricultural Refinance and Development Corporation.
- Carrying a noble mission, NABARD serves as the central brain for all things credit and development in rural India.
- From shaping policy and crafting plans to overseeing operations, NABARD ensures financial resources flow smoothly to fuel agricultural and economic activities in our vast countryside.
- Empowered with a robust capital base of Rupee 30,000 crore, NABARD plays several critical roles:
  - **Apex Financier:** It acts as the ultimate source of funds for institutions that directly finance crucial rural activities like farming and business ventures.
  - **Refinancing Lifeline:** NABARD provides a vital lifeline to financial institutions already servicing the rural sector, ensuring they have the resources to keep the engine running.
  - **RRB Watchdog:** Regional Rural Banks (RRBs) operate under NABARD's vigilant watch, ensuring effective and responsible banking practices in rural areas.
- Through these roles, NABARD's reach extends far and wide, touching various institutions:
  - State Co-operative Agriculture and Rural Development Banks (SCARDBs)
  - State Co-operative Banks (SCBs)
  - RRBs
  - Commercial Banks
  - Other RBI-approved financial institutions
- In a noteworthy move in 2019, the Reserve Bank of India relinquished its stake in NABARD, making it a **fully owned entity of the Government of India.** This empowered NABARD to chart its own course and solidify its role as the champion of rural development in India.

Small Industries Development Bank of India (SIDBI)

- Established in 1990 as a subsidiary of IDBI, later transitioning to government ownership.
- Initial focus: Refinancing loans for banks and state institutions serving small industries.
- **Evolution Beyond Finance**
  - Embraces a "Credit+" approach, offering not just funds but also:
    - **Skill upgradation programs:** Enhancing employee and entrepreneur capabilities.
    - **Marketing support:** Building brand awareness and market access for MSMEs.
    - **Cluster development projects:** Fostering collaboration and shared infrastructure.
    - **Technology modernization initiatives:** Equipping businesses with cutting-edge tools.
    - **Impactful Contributions, Economic Growth:**
  - Nurtured numerous success stories across diverse sectors, from traditional crafts to modern technology.
  - Contributes to vibrant local economies through job creation and entrepreneurial spirit.
  - Promotes inclusivity by empowering women and marginalized communities.

- **Charting the Future**
  - Plays a crucial role in India's "Make in India" initiative by supporting domestic manufacturing.
  - Embraces technology to equip MSMEs for the digital age (AI, Big Data).
  - Poised to be a key driver of India's future economic growth through continued MSME empowerment.

EXIM Bank

Export-Import Bank (EXIM Bank), established in 1982, stands as a crucial bridge connecting Indian businesses to the international trade arena. As a wholly-owned subsidiary of the Central Government, it takes center stage in supporting both exporters and importers, fueling India's economic engine through global commerce.

Gearing Up Exporters

- **Direct Financial Assistance:** Whether it's setting up a new factory or acquiring sophisticated machinery, EXIM Bank provides the financial muscle for Indian exporters to compete globally. It offers medium-term credit that empowers them to invest in the tools and technologies needed for success.
- **Short-Term Support:** Cash flow is king, and EXIM Bank understands this. By rediscounting export bills, it ensures exporters quickly receive their receivables, keeping their businesses running smoothly.

Empowering Importers

- **Bridging the Gap:** Often, access to financing is a bottleneck for international trade. EXIM Bank steps in by offering credit to foreign importers seeking Indian capital goods and services. This paves the way for seamless transactions and facilitates the flow of Indian exports to the global market.

Beyond Finance

EXIM Bank's role extends beyond just financial transactions. It actively fosters the growth of export-oriented industries in India. Through various initiatives, it:

- **Identifies potential industries:** By analyzing market trends and identifying promising sectors, EXIM Bank guides investment towards areas with high export potential.
- **Provides financial and technical support:** From access to capital to expertise in international trade practices, EXIM Bank offers a comprehensive toolbox for aspiring exporters.
- **Collaborates with other stakeholders:** Building partnerships with government agencies, industry associations, and financial institutions, EXIM Bank creates a robust ecosystem that supports export-oriented businesses.

The Impact

- EXIM Bank's tireless efforts have played a significant role in shaping India's export landscape.
- Its financial assistance has fueled countless success stories, boosting the competitiveness of Indian businesses and generating valuable foreign exchange.
- By facilitating international trade, EXIM Bank contributes to job creation, economic growth, and the overall well-being of the nation.

National Housing Bank (NHB)

- **Establishment and Mandate**
  - Instituted in 1988 under the National Housing Bank Act, 1987, as a statutory body.
  - Functions as the apex financial institution for housing in India.
  - Aims to act as a primary agency promoting housing finance institutions at local and regional levels, providing essential financial support and ancillary services.
- **Regulatory Functions**
  - Registers, regulates, and supervises Housing Finance Companies (HFCs).
  - Maintains oversight through both on-site and off-site surveillance mechanisms, collaborating with other regulatory bodies.
- **Operational Details**
  - Headquartered in Delhi, functioning under the regulatory purview of the Reserve Bank of India (RBI).
  - Previously having RBI's stake, post-2019, NHB became wholly owned by the Government of India (GOI). This transition followed the Narasimham panel's recommendation to disassociate RBI from entities it regulates, leading to the divestment of RBI's stake in NHB.

RESIDEX- the index measures inflation in residential house prices in selected Indian cities against the base year 2017.

Budget 2023 has announced the setting up of an Urban Infrastructure Development Fund (UIDF) through the use of Priority Sector Lending (PSL) shortfalls. The Fund will be managed by the NHB and will be used by the State/ UT governments, public agencies, etc to create urban infrastructure primarily in Tier 2 and Tier 3 cities. This Fund will be operationalised broadly along the lines of the existing Rural Infrastructure Development Fund (RIDF) which is managed by NABARD.

MUDRA Bank

- **Establishment and Purpose**
  - Established in 2015 by the Government of India (GOI), MUDRA Bank's primary objective is to offer low-interest loans to Micro Finance Institutions (MFIs) and non-banking financial institutions. These entities further extend credit to Micro, Small, and Medium Enterprises (MSMEs).
  - Set up under the Pradhan Mantri MUDRA Yojana scheme.

❑ **Eligible Borrowers**

- Individuals eligible to borrow from MUDRA Bank encompass a wide range, including small manufacturing units, service sector units, shopkeepers, fruit/vegetable vendors, truck operators, food-service units, repair shops, machine operators, artisans, food processors, and others, operating in both rural and urban areas.

❑ **Loan Products**

- MUDRA Bank categorizes its loan products as 'Shishu,' 'Kishore,' and 'Tarun,' signifying the growth stage of beneficiary micro units/entrepreneurs.

Category of Loan	Limit on Amount
Shishu	Upto ₹ 50,000
Kishor	From ₹ 50,000 upto ₹ 5 lakhs
Tarun	From ₹ 5 lakhs upto ₹ 10 lakhs

❑ **Refinance Support and Assistance**

- In addition to lending, MUDRA Bank extends refinance support to Regional Rural Banks (RRBs) to enhance their liquidity and facilitate their operations.

Former RBI Governor Raghuram Rajan had warned of the rising NPAs under the PMMY in 2018 which doubled in the next one year to the tune of ₹ 16,481 crores. Further, only 20% of the loans were used to start new businesses. In the year 2022, the total NPAs as a percentage of credit disbursed under the PMMY stood at 3.17% according to the official data provided by the government.

National Bank for Financing Infrastructure & Development (NaBFID)

❑ **Establishment and Legal Framework**

- The National Bank for Financing Infrastructure and Development (NaBFID) was established in 2021 through the enactment of The National Bank for Financing Infrastructure and Development (NaBFID) Act, 2021.
- Introduced during the Budget 2021, NaBFID functions as India's dedicated Development Finance Institution (DFI).

❑ **Objectives of NaBFID**

- Provide financial support for infrastructure projects.
- Encourage investments from private sector and institutional investors in infrastructure projects.
- Facilitate and encourage foreign engagement in Indian infrastructure initiatives.
- Foster growth in the market for infrastructure financing instruments like bonds, loans, and derivatives.

❑ **Capital Raising and Structure**

- Authorized as a corporate entity with an initial authorized share capital of one lakh crore rupees.
- Empowered to raise funds in both Indian rupees and foreign currencies through loans, bonds, debentures from sources such as the Government, Banks, Multilateral institutions, or other Financial institutions.

❑ **Positioning and Regulation**

- Designated as India's Fifth All-India Financial Institution (AIFI).
- Regulated and supervised by the Reserve Bank of India (RBI) to ensure compliance and effective operation.

Non-Banking Financial Companies(NBFCs)

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956, engaged in various financial activities such as loans, advances, acquisition of shares, stocks, bonds, debentures, securities issued by the Government or local authorities, leasing, hire-purchase, insurance business, and chit business.

Primary Dealers	Primary Dealers (PD) operate in the Primary Market to directly buy fresh Government securities (G-Secs) from the RBI and sell them in the Secondary Market. For eg. Goldman Sachs (India) Capital Markets Pvt. Ltd
Mutual Funds	Mutual Funds pool clients' money which is thereafter invested by a Mutual Fund Manager to earn a greater interest rate for its clients. For eg. SBI Nifty Index Fund
Insurance Funds	An Insurance Fund pools money from its participants and invests them in market securities in order to accumulate profits and cover policyholder's claims and liabilities. For eg. Aditya Birla Sun Life Insurance
Pension Funds	A pension fund is a type of investment fund that accumulates capital to be paid out as pension to the plan participants when they retire at the end of their careers. For eg. National Pension Scheme (NPS), Public Provident Fund (PPF), Employee Provident Fund (EPF), etc
Micro-finance	Microfinance institutions were created by the RBI in 2010 to provide small collateral-free loans to poorer sections of the society. For eg. Equitas Small Finance, Annapurna Microfinance Pvt Ltd, etc

It plays a significant role in India's financial landscape. While not banks themselves, they offer various financial services, making them crucial players in fueling economic growth and individual progress.

- **Wide Range of Services**
  - **Loans and Advances:** They offer diverse loan options beyond traditional banks, from personal loans to equipment financing and business loans.
  - **Financial Instruments:** NBFCs deal in buying and selling shares, bonds, debentures, and other financial instruments, providing liquidity and investment opportunities.
  - **Beyond Banking:** NBFCs can delve into other areas like leasing, insurance, chit funds, and more, expanding access to financial services for specific needs.
- **Key Regulations**
  - **RBI Oversight:** Most NBFCs fall under the regulatory umbrella of the Reserve Bank of India (RBI), ensuring operational standards and consumer protection.
  - **SEBI and IRDA:** Specialized regulators like SEBI (Securities and Exchange Board of India) and IRDA (Insurance Regulatory and Development Authority) oversee specific types of NBFCs like VC funds and insurance companies.
  - **Minimums and Restrictions:** RBI mandates that an NBFC's financial assets comprise over 50% of its total assets and income from these assets surpasses 50% of its gross income. They are also prohibited from accepting demand deposits like bank savings accounts.
- **Funding Mechanisms**
  - **Debentures and Bonds:** Issuing debentures and bonds allows NBFCs to raise capital from investors without accepting demand deposits, providing them with a crucial funding channel.
  - **Other Sources:** They can also access funds through equity investments, partnerships, and other financial instruments.
- **FDI and Growth**
  - **FDI Boost:** Allowing 100% Foreign Direct Investment (FDI) in specific NBFC activities has attracted international expertise and capital, bolstering the sector's growth.
  - **Economic Significance:** NBFCs contribute significantly to financial inclusion by reaching underserved segments and offering diverse financial products, fostering economic development.

Types of NBFCs

NBFCs are classified into different types based on factors such as liability structure, size, and the nature of activities they perform. However, It's important to note that each of these types is subject to different regulations and norms. These include:

1. **Asset Finance NBFCs:** These champions help individuals and businesses acquire assets like vehicles, machinery, or equipment.
2. **Investment NBFCs:** Think mutual funds, venture capital funds, and stock broking houses – these fall under the investment NBFC umbrella.
3. **Loan Companies:** From personal loans to home loans and microfinance, these NBFCs cater to individual borrowing needs.
4. **Infrastructure Finance NBFCs:** Building bridges, powering hospitals, and connecting people through transport - these NBFCs specialize in financing critical infrastructure projects.
5. **Factoring NBFCs:** Imagine unlocking business cash flow. Factoring NBFCs do just that, buying outstanding invoices from businesses and providing immediate liquidity.
6. **Housing Finance NBFCs:** Owning a dream home becomes feasible with the support of these NBFCs.
7. **Microfinance NBFCs:** Empowering small entrepreneurs and vulnerable sections through microloans is the domain of microfinance NBFCs.

Difference Between Banks and NBFCs

Banks	NBFCs
Can accept demand deposits from the public.	Unable to accept demand deposits from the public.
Can issue cheques drawn on themselves.	Cannot issue cheques drawn on itself.
Integral part of the payment system.	Not part of the payment and settlement system.
Deposits are often insured by DICGC.	Deposit insurance not available for NBFC investors.
Required to maintain Reserve Ratios (CRR, SLR).	Not mandated to maintain RBI-prescribed ratios.

NBFCs and Liquidity Crisis

- **RBI's Prudential Norms**
  - Aim to discourage NBFCs (NBFC-D) from accepting deposits and encourage the growth of non-deposit-taking NBFCs (NBFC-ND) to protect depositor capital, as NBFC-D deposits lack DICGC coverage, risking potential total loss for depositors.
- **Shift to Wholesale Funding**
  - NBFCs increasingly rely on wholesale funding sources such as loans from Banks, Debt Mutual Funds, Debentures, and Commercial Papers due to the regulatory emphasis on non-deposit-taking models.
- **Preference for Short-term Financing**
  - Financial institutions and NBFCs favour short-term financing due to its lower cost, easy availability, and liquidity, leading to a reliance on frequent short-term funding sources.

- **Asset Liability Management Challenges**
  - The dependency on short-term funding creates Asset Liability Management (ALM) issues, leaving NBFCs vulnerable to increased costs and repayment pressures associated with short-term loans.
- **Connection with Liquid Debt Mutual Funds (LDMF)**
  - Liquid Debt Mutual Funds serve as a primary source of short-term funds for NBFCs, establishing a strong interconnection between the two sectors.
- **Systemic Risk Transmission**
  - The performance of the NBFC sector significantly impacts Liquid Debt Mutual Funds, potentially exposing mutual funds to systemic risks originating from the NBFC sector.
- **Risk of Redemptions and Systemic Impact**
  - Shocks in the NBFC sector might trigger substantial investor redemptions in Liquid Debt Mutual Funds at lower prices, potentially leading to systemic repercussions in the financial sector.
- **Governmental Policy Changes**
  - Recent policy changes by the government aim to address these vulnerabilities and mitigate potential systemic risks arising from the interdependence of NBFCs and Liquid Debt Mutual Funds.

Major Policy Changes in India's NBFC Sector: A Recent Landscape

The Indian government has implemented several crucial policy changes for the NBFC sector in recent years, aiming to bolster its stability, mitigate systemic risks, and promote responsible growth.

1. **Enhanced Capital Adequacy**

- **Risk-based Capital Framework:** Introduced in 2019, this framework aligns capital requirements with risk profiles, ensuring stronger financial buffers for higher-risk NBFCs.
- **Increased minimum capital levels:** Minimum Net Owned Funds (NOF) requirements have been steadily raised, currently set at ₹ 25 crore for NBFC-NDs and ₹ 50 crore for NBFC-Ds. This provides greater resilience to shocks.

2. **Strengthened Liquidity Regulations**

- **Liquidity Coverage Ratio (LCR):** Introduced in 2016, LCR mandates NBFCs to maintain enough liquid assets to cover short-term liabilities under stress scenarios.
- **Statutory Liquidity Ratio (SLR):** Applicable to NBFC-Ds since 2020, SLR requires them to invest a part of their deposits in government securities, enhancing liquidity and stability.

3. **Improved Governance and Regulatory Framework**

- **Fit and Proper Guidelines:** Enhanced due diligence for promoters and directors ensures ethical standards and responsible operations within NBFCs.
- **Resolution Framework:** Establishment of a resolution framework for stressed NBFCs aims to address potential financial instability and protect depositors' interests.

MICROFINANCE INSTITUTIONS

Microfinance institutions (MFIs) are specialized financial institutions dedicated to providing small loans, savings services, and other financial products to low-income individuals and groups. These individuals often lack access to traditional banking services due to various factors like lack of collateral, low credit scores, or informal employment.

Regulatory Bodies

- **Reserve Bank of India (RBI):** Acts as the primary regulator for MFIs, issuing guidelines, conducting inspections, and overseeing compliance.
- **Microfinance Regulatory Authority (proposed):** The proposed bill envisaged creating a dedicated MFI regulatory authority for more focused oversight and consumer protection.

Key Features of MFIs

- **Small Loans:** MFIs typically offer loans ranging from all loans below 1 lakh can be categorized as microloans in India. catering to the varied needs of micro-entrepreneurs, farmers, artisans, and other low-income individuals.
- **Flexible Repayment:** Payment schedules are designed to be manageable for borrowers with irregular income streams, often involving weekly or bi-weekly installments.
- **Group Lending:** In some cases, MFIs employ group lending models, where a group of borrowers acts as guarantors for each other. This mitigates risks and fosters social accountability.
- **Financial Education:** Many MFIs provide financial literacy training and business development services to their clients, empowering them to make informed financial decisions and grow their businesses.

Prominent Indian MFIs

- **Bandhan Financial Services:** One of the largest MFIs in India, serving primarily women borrowers through group lending models and focusing on rural areas.
- **Equitas Small Finance Bank:** A leading MFI-turned-small finance bank, offering diverse financial services including microloans, savings accounts, and deposits.
- **Ujjivan Financial Services:** Provides microloans and other financial products to individuals and small businesses across urban and rural India.

Benefits of Microfinance

- **Poverty Reduction:** By providing access to capital, MFIs enable individuals to start or expand their businesses, generate income, and improve their livelihoods.

- **Women Empowerment:** Women are often the primary beneficiaries of microfinance, leading to increased household income and greater decision-making power within the family.
- **Community Development:** By promoting financial inclusion and economic activity, MFIs contribute to overall community development and poverty reduction.

Challenges and Criticisms

- **High Interest Rates:** MFI loan interest rates can be higher than traditional banks, raising concerns about potential debt traps for borrowers.
- **Over-indebtedness:** Access to easy credit can sometimes lead to borrowers taking on more debt than they can handle.
- **Sustainability:** Some MFIs may struggle with financial sustainability due to high operating costs and reliance on donor funding.

IGNITE YOUR MIND

Do you think the benefits of microfinance, such as poverty reduction and women's empowerment, outweigh the challenges associated with high-interest rates and potential over-indebtedness? How can a balance be struck between providing access to credit for vulnerable populations and ensuring the financial sustainability of MFIs?

Despite these challenges, microfinance remains a valuable tool for poverty reduction and financial inclusion. Responsible lending practices, financial education, and effective regulation are crucial in ensuring the positive impact of MFIs on individuals and communities.

NBFC Supervision & Regulation

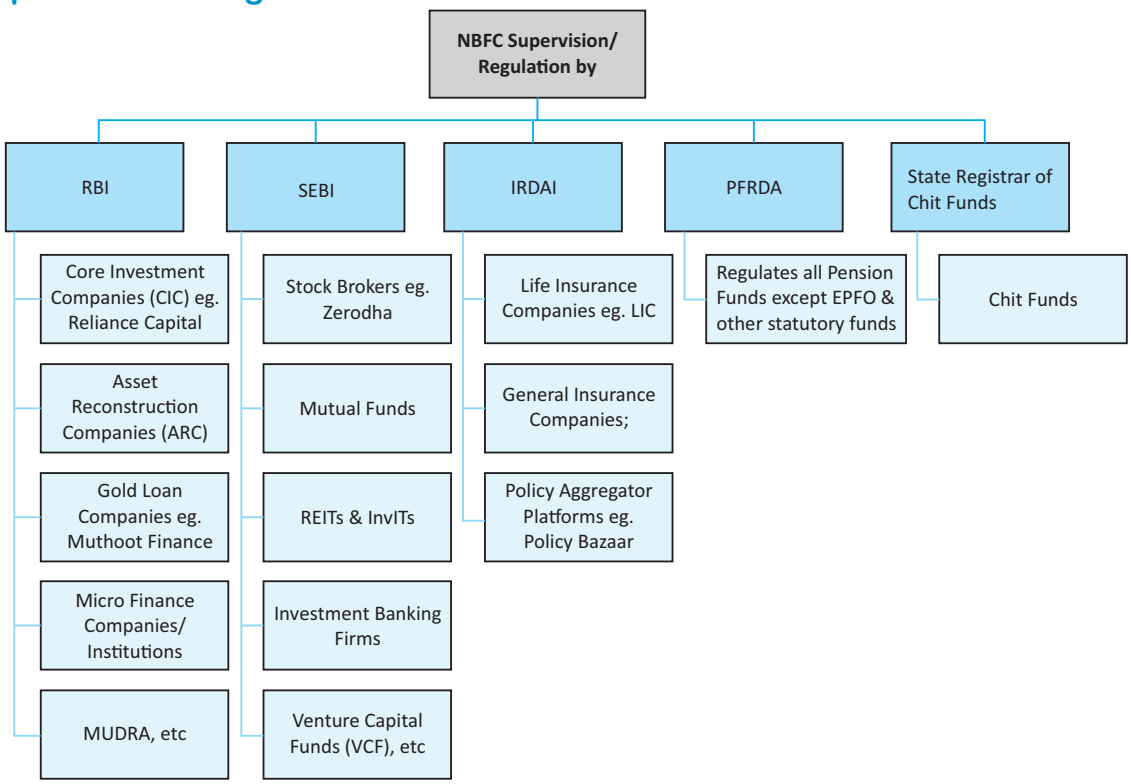


Fig. 8.5: NBFC Supervision/Regulation

Steps Taken For Supervision and Regulation of NBFCs

- RBI as the Regulator of AIFIs and NBFC-D (deposit taking).
- RBI's separate ombudsman for NBFCs.
- RBI's DAKSH Web Portal- It allows banks/NBFCs to send their reports to the RBI enabling it to monitor them more effectively.
- Resolution Framework 1.0 and 2.0 (2020-21)- Based on the recommendations of the KV Kamath committee, RBI issued a set of guidelines for Bank/ NBFCs for dealing with the bad loans after the Corona crisis. For instance, restructuring of loans, etc.
- RBI's Prompt Corrective Action (PCA) framework for NBFCs.
  - RBI monitors NBFCs based on three parameters vis a vis NPAs, BASEL Capital Adequacy Ratio (CAR), and BASEL Tier 1 Capital.
  - However, these norms are only applicable to NBFC-Ds i.e., Deposit taking NBFCs. These are not applicable to Government owned NBFCs such as UTI Mutual Fund, Primary Dealers, Housing Finance Companies (HFCs), Non Deposit taking NBFCs such as IL&FS, etc.

- RBI's Utkarsh 2022 Roadmap
  - The roadmap was introduced by the RBI in 2019 to aim at improving its regulation of NBFCs based on global best practices by the year 2022.
- National Financial Information Registry (NFIR)- proposed in the Budget 2023.
  - Designed with the help of RBI, the NFIR will contain all the information of individual as well as corporate borrowers on the loans taken by them through Banks, NBFCs, etc. It will help in providing a piece of comprehensive information about a loan applicant's creditworthiness thereby helping lenders in better risk assessment.

Neo Banks

Neo Banks are completely online-based digital banking platforms that lack any physical presence. Although NITI AAYOG has recommended their introduction to enhance banking accessibility in India, however, these are yet to get approval from the RBI.

Characteristics of Neo Banks

- **Digital Operations:** Conduct banking services primarily through mobile apps or websites, devoid of physical branches.
- **Emphasis on Technology:** Leverage innovative tech, analytics, and AI to provide efficient and personalized banking experiences.
- **Customer Focus:** Target tech-savvy individuals comfortable with digital banking, offering user-friendly and seamless interactions.
- **Agility and Innovation:** Agile operations and a focus on leveraging cutting-edge technology to streamline processes and enhance user experience.
- **Regulatory Framework:** Operate within the regulatory guidelines and framework set by the Reserve Bank of India (RBI).
- **Example:** Yono by SBI, RazorpayX.

Role in The Indian Economy

- **Emerging Players:** Neo banks have surfaced in the Indian market, catering to specific segments of the population, especially those inclined towards digital banking solutions.
- **Services Offered:** Provide a range of banking solutions such as savings, payments, investments, lending, and sometimes niche offerings tailored to particular industries or demographics.
- **Partnerships:** Often collaborate with traditional banks to access infrastructure, banking licenses, and regulatory compliance.

Challenges and Opportunities

While promising, Neo banks also face hurdles. Building trust in a completely virtual environment can be challenging, and regulatory frameworks for these new players are still evolving. However, their sheer agility and innovative spirit hold immense potential to revolutionize the banking landscape in India:

- **Financial Inclusion:** Reaching remote areas and unbanked populations with convenient and affordable digital banking solutions.
- **Financial Literacy:** Promoting financial awareness and responsible money management through engaging digital tools and gamification.
- **Enhanced Competition:** Pushing traditional banks to innovate and improve their customer offerings to compete with the efficiency and convenience of Neo banks.

ACCOUNTS AND DEPOSITS

Deposits

- **Time Deposit:** Time deposits are bank accounts that allow you to deposit money for a fixed term and earn a fixed interest rate. You cannot withdraw the money before the term ends without paying a penalty.
  - Some examples of time deposits are **certificates of deposit (CDs) and term deposits.**
  - Time deposits usually offer higher interest rates than regular savings accounts, but they are less liquid and flexible.
- **Demand Deposit:** Demand deposits are bank accounts that allow you to withdraw money at any time without notice. They are usually used for daily expenses and purchases.
  - Some common types of demand deposits are **checking accounts and savings accounts.**
  - Demand deposits pay little or no interest, but they are very liquid and convenient.

Types of Accounts

- **Savings Account:** This is a type of bank account for personal use. You can deposit and withdraw money as per your needs, but there are some limits on how often and how much you can do so. Banks usually ask you to keep a certain amount of money in the account to cover their expenses. You get interest on the money you save in this account.
  - **Example:** Setting aside funds for daily transactions.
- **Current Account:** This is a kind of bank account that lets you deposit and withdraw money whenever you want. You can do as many transactions as you need and for any amount. These are the easiest deposits to access. Current account is mainly for business use/firms and not for saving money. Banks do not give interest on these accounts and they charge some fees for these accounts. Banks offer easy and flexible services on these accounts and also give cheque books.

Accounts maintained by NRI/PIO

NRI/PIO individuals have the option to maintain various types of accounts in India, including

- **Foreign Currency Non-Resident (FCNR) Account:** This account can be held in any freely convertible **foreign currency**, exclusively as term deposits. Both the interest and principal are non-taxable and can be freely repatriated.
- **Non-Resident External (NRE) Account:** Available in **Indian Rupees**, this account can take the form of Current, Savings, Recurring, or Fixed Deposit. Similar to FCNR, the interest and principal are non-taxable and can be freely repatriated.
- **Non-Resident Ordinary (NRO) Account:** Maintained in **Indian Rupees**, this account offers flexibility as Current, Savings, Recurring, or Fixed Deposit. While the principal and interest are taxable, repatriation is restricted. It is suitable for depositing income earned from Indian sources like rent, dividends, or pensions.

- **NRI (Non-Resident Indian) Accounts:** Designed for individuals abroad to manage finances in their home country.
  - **Example:** An NRI opening an account for remittances and asset management.
- **Demat Account:** Holds financial securities in electronic form for online trading.
  - **Example:** Necessary for buying and selling stocks, bonds, and mutual funds electronically.
- **Joint Account:** Held by two or more individuals sharing access to funds and transactions.
  - **Example:** Spouses opening a joint account for shared expenses.
- **Recurring Deposit Account:** It is a form of term deposit tailored for individuals without a substantial lump sum of savings but willing to save a modest amount monthly, quarterly, or half-yearly. These deposits accrue interest on the deposited amount, similar to fixed deposits. The maturity period typically ranges from 6 months to 10 years.

PAYMENT SYSTEM OPERATOR AND REGULATOR

Payment System Operator

RBI as Payment System Operator

- **NEFT:** NEFT stands for National Electronic Funds Transfer. It is a system that allows you to transfer money from one bank account to another in India. NEFT is not instant, but it is processed in half-hourly batches. You can use NEFT online or offline, and there is no limit on the amount you can transfer. NEFT is available 24 × 7, 365 days.
- **RTGS:** RTGS stands for Real-Time Gross Settlement. It is a system that allows you to transfer money from one bank account to another in India instantly and securely. RTGS is used for high-value transactions, as the minimum amount is ₹ 2 lakh. RTGS is operated by the Reserve Bank of India (RBI) and is available 24 × 7. RTGS has many benefits, such as speed, reliability, transparency, and convenience.

National Payments Corporation of India (NPCI)

The National Payments Corporation of India (NPCI) is an organisation formed by the Reserve Bank of India (RBI) and the Indian Banks' Association (IBA) under the Payment and Settlement Systems Act, 2007. Its purpose is to establish a robust payment and settlement infrastructure in India.

- NPCI operates as a "**Not for Profit" Company** Companies Act 2013, aiming to provide infrastructure for the entire Indian banking system's physical and electronic payment and settlement systems.
- The company focuses on leveraging technology to bring innovations to retail payment systems, enhancing operational efficiency, and expanding the reach of payment systems.
- The **ten core promoter banks** include State Bank of India, Punjab National Bank, Canara Bank, Bank of Baroda, Union Bank of India, Bank of India, ICICI Bank Limited, HDFC Bank Limited, Citibank N. A., and HSBC.
- In 2016, the shareholding was expanded to 56 member banks, representing various sectors, and in 2020, new entities regulated by the RBI were included.

Major Initiatives of NPCI

Payment Services Portfolio

A. Payment and Settlement Systems in India: Vision-2018

The Reserve Bank of India (RBI) has unveiled the Vision-2018 document, outlining its ambition to establish cutting-edge payment and settlement systems to propel India towards a 'less-cash' economy. Encompassing the principles of coverage, convenience, confidence, convergence, and cost (5 Cs), Vision-2018 aims to achieve these goals through four strategic initiatives: responsive regulation, robust infrastructure, effective supervision, and customer centricity.

As part of Vision-2018, the RBI will introduce a comprehensive Digital Payments Index (DPI) periodically, providing insights into the level of digitization in payment systems.

B. Unified Payments Interface (UPI)

Unified Payments Interface (UPI), crafted by the National Payments Corporation of India (NPCI), seamlessly integrates multiple bank accounts into a single mobile application from any participating bank. Launched in April 2016, UPI has become a favoured choice for users engaging in efficient money transfers. Key Characteristics of UPI:

- **Smartphone-enabled Transfers:** UPI facilitates direct money transfers between any two bank accounts via smartphones.
- **Convenient Merchant Payments:** Users can pay merchants, both online and offline, without entering credit card details, IFSC codes, or net banking/wallet passwords.
- **Peer-to-Peer Collect Requests:** UPI accommodates "Peer to Peer" collect requests, allowing scheduled and convenient payments.
- **Upgraded Version - UPI 2.0:** Launched in 2018, UPI 2.0 introduces features like "Invoice in the Inbox," "One-time Mandate," "Linking of Overdraft Account," and "Signed Intent and QR" for enhanced security.

C. BHIM (Bharat Interface for Money)

Developed by the National Payments Corporation of India (NPCI) and launched on December 30, 2016, BHIM is a payment app designed to facilitate uncomplicated transactions through the Unified Payments Interface (UPI). Key Features of BHIM:

- **Instant Bank-to-Bank Payments:** BHIM enables quick bank-to-bank payments using just a mobile number or UPI ID (Virtual Payment Address).
- **Accessibility on Feature Phones:** BHIM extends its functionality to feature phones and operates without internet connectivity through the USSD framework *99#.

D. Bharat QR

Bharat QR is a QR-based payment solution designed for **Person-to-Merchant (P2M)** digital payments. It stands out as the world's first interoperable Quick Response (QR) code acceptance solution, created collaboratively by the National Payments Corporation of India (NPCI), **Mastercard, and Visa**. This innovative system plays a pivotal role in expediting India's transition towards a less-cash society.

The QR code Payment System involves essential parties:

- **Acquirer:** Responsible for merchant onboarding, management, and mobile app solutions.
- **Issuer:** Handles consumer onboarding and provides consumer mobile app solutions.
- **Transaction Processing Engine (NPCI):** Serves as the end transaction routing engine for seamless operation.

E. NACH (National Automated Clearing House)

National Automated Clearing House (NACH) is a system that enables electronic transfer of funds between bank accounts in India.

- It is operated by the NPCI and can be used for various purposes, such as salary, pension, subsidy, dividend, bill payment, etc.
- NACH has two components: NACH Credit and NACH Debit. NACH Credit allows the transfer of funds from one account to many accounts, while NACH Debit allows the transfer of funds from many accounts to one account.
- NACH is faster, cheaper, and more secure than the previous Electronic Clearing Service (ECS) system.

F. AePS (Aadhaar-enabled Payment System)

Aadhaar-enabled Payment System (AePS) is a system that allows you to use your Aadhaar number and biometric authentication to access various banking services, such as cash withdrawal, balance enquiry, fund transfer, and more.

- You can use AePS at any micro-ATM or point of sale (PoS) device that supports Aadhaar authentication.
- AePS is operated by the NPCI and is part of the National Automated Clearing House (NACH) platform.
- AePS is a secure, convenient, and user-friendly way to make financial transactions using your Aadhaar card

G. APBS (Aadhaar Payment Bridge System)

- Aadhaar Payment Bridge System (APBS) is a system that allows the government to transfer subsidies and benefits to the Aadhaar-linked bank accounts of the beneficiaries.
- It is operated by the NPCI and is part of the National Automated Clearing House (NACH) platform.
- APBS uses the Aadhaar number as the financial address of the recipient, and eliminates the need for providing bank account details or IFSC codes.
- APBS is faster, cheaper, and more secure than the previous methods of direct benefit transfer.

H. National Financial Switch (NFS)

- National Financial Switch (NFS) is the largest network of shared automated teller machines (ATMs) in India.
- NFS allows you to use any ATM of a connected bank, regardless of whether you have an account with that bank or not.
- You may have to pay a fee if you use an ATM of a different bank than your own.
- NFS also enables other services, such as e-commerce payment gateway, Aadhaar Payment Bridge System, and Aadhaar-enabled Payment System.

I. Bharat Bill Payment System

A one-stop solution for recurring payments, offering bill payment services across various categories like electricity, gas, water, telecom, and more.

J. National Electronic Toll Collection (NETC)

National Electronic Toll Collection (NETC) is a system that allows you to pay toll fees electronically using a RFID tag called FASTag.

- It is operated by the NPCI and covers more than 1000 toll plazas across the country.
- NETC is fast, secure, and convenient, and it saves fuel and time by avoiding cash transactions and queues at toll plazas.

K. Immediate Payment Service (IMPS)

IMPS is an instant interbank electronic fund transfer system in India.

- It allows you to send and receive money using your mobile phone or internet banking, 24x7, throughout the year.

RUPAY Cards are payment cards issued by the National Payments Corporation of India (NPCI) that can be used for online and offline transactions in India and abroad.

- RUPAY Cards are accepted at over 6 million merchant outlets and 2.6 lakh ATMs in India, and over 1.9 million ATMs and 39 million merchant outlets across 190 countries globally.
- RUPAY Cards offer various benefits, such as low transaction costs, security features, cashback, discounts, and rewards.

- You can use either a mobile number and MMID or an account number and IFSC code to transfer money via IMPS.
- The maximum amount you can transfer per day is ₹ 5 lakh.
- You may have to pay a nominal charge and a service tax for using IMPS.

Other Payment Systems

Credit card and Debit Card

Credit Cards:

- A credit card is a payment card that allows you to buy goods and services on credit, which means borrowing money from the card issuer up to a certain limit.
- You have to pay back the amount you spend, either in full or in instalments, with interest.
- Credit cards can offer various benefits, such as rewards, discounts, cashback, and security. However, they can also have drawbacks, such as fees, penalties, debt, and fraud.

Debit Cards

- A debit card is a payment card that deducts money directly from your bank account when you make a purchase.
- It can also be used to withdraw cash from an ATM.
- Unlike a credit card, a debit card does not involve borrowing money or paying interest.
- However, using a debit card may incur some fees, such as ATM transaction fees, insufficient funds fees, or overdraft fees.
- Some debit cards may also offer rewards or discounts for certain purchases.
- To use a debit card, you may need to enter a PIN (personal identification number) or sign a receipt.

Mastercard and VISA

Mastercard and VISA is a multinational financial services corporation that operates a vast global payment network. It provides payment solutions through credit cards, debit cards, and prepaid cards. In a financial transaction, when a consumer uses a Mastercard or VISA card, the cardholder's issuing bank authorises the transaction, and facilitates the secure transfer of funds between the issuing bank and the merchant's acquiring bank.

Their role involves processing these transactions efficiently, ensuring security through technologies like EMV chips and tokenization.

Merchant Discount Rate (MDR)

MDR, also known as the transaction discount rate (TDR), is essentially a fee imposed on a merchant by their issuing bank for accepting payments from customers through credit and debit cards. Before integrating debit and credit cards as payment methods, the merchant must establish this service and agree upon the applicable rate.

MDR serves as compensation for the issuing bank, the bank responsible for the Point of Sale (PoS) terminal installation, network providers, and payment gateways for their respective services. It encompasses all charges and taxes associated with electronic or digital payments. This includes bank fees levied on customers and vendors for digital payments and transaction processing costs paid by payment aggregators to virtual or mobile platforms or banks. MDR charges are represented as a percentage of the transaction amount, with rates influenced by the volume of business transactions, the types of cards used (debit or credit), and the average transaction value, also known as average tickets or average sales.

Difference Between RTGS, IMPS and NEFT

Points of difference	NEFT	RTGS	IMPS
Full form	National Electronic Funds Transfer	Real-Time Gross Settlement	Immediate Mobile Payments Services
Launched by	RBI	RBI	NPCI
Fund settlement time	Half-hourly batches	Real-time	Real-time
Service availability	Available 24x7, 365 days	Available 24x7, 365 days	Available 24x7, 365 days
Payment options	Online and offline	Online and offline	Online

Points of difference	NEFT	RTGS	IMPS
Process speed	Slow	Faster	Faster
Minimum transfer limit	₹ 1	₹ 2 lakh	₹ 1
Maximum transfer limit	No limit (Exception – ₹ 50,000 for cash-based remittance within India and Nepal)	No limit	₹ 5 lakh

Payments System Regulator

A well-functioning payment system enhances market efficiency and lowers the costs associated with the exchange of goods and services. Conversely, its breakdown can erode confidence in the financial system and the very use of currency.

Reserve Bank of India (RBI):

- **Primary Regulator:** The RBI plays the main role in regulating payment systems, exercising authority under the Payment and Settlement Systems Act (PSS Act) of 2007.
- **Functions:**
  - Oversees the functioning of all payment systems in India.
  - Issues licences to payment system operators and participants.
  - Sets standards and regulations for payment systems, including security, risk management, and data privacy.
  - Conducts inspections and audits to ensure compliance with regulations.
  - Takes corrective action in case of non-compliance or systemic risks.

Board for Regulation and Supervision of Payment and Settlement Systems (BPSS):

- **Advisory Body:** The BPSS is an advisory committee constituted within the RBI to assist in its regulatory functions for payment systems.
- **Composition:** Comprises senior RBI officials, representatives from various financial institutions, and independent experts.
- **Functions:**
  - Advises the RBI on formulating regulatory policies and guidelines for payment systems.
  - Reviews the performance of payment systems and identifies areas for improvement.
  - Recommends measures to enhance the safety, efficiency, and security of payment systems.

Additionally, other entities play supporting roles in the regulatory landscape:

- **National Payments Corporation of India (NPCI):** Operates key retail payment systems like UPI, RuPay, and NFS, and adheres to RBI regulations.
- **Ministry of Finance and other government agencies:** Collaborate with the RBI on formulating policy and regulatory frameworks for payment systems.
- **Self-Regulatory Organizations (SROs):** Established by payment industry participants to develop and enforce codes of conduct and best practices in specific segments.

The current regulatory framework in India aims to:

- Promote innovation and competition in the payment system landscape.
- Ensure the safety, security, and efficiency of payment systems.
- Protect consumer interests and prevent fraud.
- Foster a cashless and inclusive digital payments ecosystem.

Digital Transactions Ombudsman (2019)

- In 2019, the RBI appointed senior officials at 21 locations throughout India as Digital Transactions Ombudsman (DTO).
- These designated individuals are responsible for addressing customer complaints up to ₹ 20 lakh related to prepaid payment instruments, mobile wallets, apps, NEFT/RTGS, and other digital transactions.
- The DTOs have the authority to instruct the company or bank involved to rectify or settle the transaction, with the provision to compensate the customer with an additional ₹ 1 lakh for mental distress. The aggrieved party can make a higher appeal to the Deputy Governor of RBI.
- If the amount in question exceeds ₹ 20 lakh, the matter falls outside the DTO's jurisdiction, requiring the victim to seek resolution through ordinary courts or consumer courts, depending on the nature of the case.

Recommendations of Nandan Nilekani Panel on Deepening of Digital Payments

- The RBI is advised to formulate a region-specific **'Digital Financial Inclusion Index'** to assess progress and implement corrective measures as needed.
- Ensure that no user resides more than 5 kilometres away from a banking access point.
- Empower local vendors to serve as Banking Correspondents (BCs).
- Establish an **Acceptance Development Fund (ADF)** aimed at enhancing digital payment infrastructure in underserved areas, including subsidies for Point of Sale (PoS) devices. Both the RBI and banks should jointly contribute funds to this initiative.

- Lower the Merchant Discount Rate (MDR) or card payment fees, enabling customers to conduct a certain number of digital payment transactions each month without incurring charges.
- The RBI should make **NEFT services available 24/7** and reassess fees associated with its usage. (As of June 2019, the RBI eliminated charges for both NEFT and RTGS, instructing banks to pass on the benefits to customers.)
- Encourage the National Payments Corporation of India (NPCI) to extend the availability of RuPay and BHIM UPI services to other countries, facilitating remittances to India.
- Promote the development and usage of digital payment apps and software in local languages.

Financial Sector Reforms in India

1. Recommendations of The Committee on Financial Sector Reforms (CFS)

The Committee on Financial Sector Reforms (CFS) was constituted in 2007 by the Government of India to examine and suggest reforms in the financial sector. Chaired by Raghuram Rajan, the committee aimed to modernize India's financial system to meet the challenges of economic growth and global integration.

- **Objective:** The primary objective was to propose measures for enhancing the efficiency, stability, and inclusiveness of the financial system.
- **Key Focus Areas:**
  - **Banking Sector Reforms:** Proposed measures to strengthen banks, improve governance, encourage competition, and expand financial inclusion.
  - **Capital Market and Infrastructure Development:** Recommendations aimed at boosting the depth and liquidity of capital markets, facilitating foreign investment, and upgrading market infrastructure.
  - **Insurance and Pension Sector:** Suggested reforms for enhancing the insurance and pension sectors, including regulatory improvements and product innovations.
  - **Regulatory Framework:** Emphasized the need for an effective regulatory framework, proposing changes in regulatory structures and norms to foster stability and growth.
- **Impact:**
- The CFS report served as a blueprint for subsequent reforms in the financial sector. Several recommendations were considered and implemented by regulatory authorities and the government.
- Its suggestions laid the groundwork for numerous policy changes and initiatives, fostering improvements in the financial landscape of the country.

2. The Financial Stability and Development Council (FSDC)

- The Financial Stability and Development Council (FSDC) is a regulatory body and forum in India that was established to strengthen and institutionalise the framework for maintaining financial stability and promoting financial sector development in the country.
- It was set up in December **2010** and is chaired by the **Finance Minister of India**.
- The FSDC serves as a high-level **platform for coordination** among various financial regulators and government agencies to address systemic risks and challenges in the Indian financial system.
- The FSDC is **not a statutory body**.
- It was established by a notification published in the official gazette.
- Its members include the heads of financial sector Regulators **(RBI, SEBI, PFRDA, IRDA)**, the Chairperson of Insolvency and Bankruptcy Board of India (IBBI), Chief Economic Advisor and secretaries from ministry of finance, ministry of Information Technology and ministry of Corporate Affairs.

3. Role of the Financial Stability and Development Council (FSDC)

- **Macroeconomic Coordination:**
  - Fosters coordination between various financial sector regulators and government agencies.
  - Monitors systemic risks and vulnerabilities in the financial system.
  - Formulates and implements policies to maintain financial stability.
- **Financial Regulation and Supervision:**
  - Provides guidance and advice to the RBI and other regulators on regulatory and supervisory matters.
  - Reviews and recommends improvements to the regulatory framework.
  - Promotes harmonisation of regulatory standards across financial institutions.
- **Financial Inclusion:**
  - Oversees the implementation of financial inclusion initiatives.
  - Develops strategies to expand access to financial services for all.
  - Monitors progress and identifies challenges in achieving financial inclusion.
- **Research and Development:**
  - Researches financial sector issues and trends.
  - Disseminates information and knowledge to stakeholders.
  - Promotes innovation and best practices in the financial sector.

BANKING SECTOR: REFORMS

Basel Norms

The Basel Accords, **consisting of Basel I, II, and III, are a series of three successive banking regulation agreements** established by the Basel Committee on Bank Supervision (BCBS). The Committee issues recommendations on banking and financial regulations, particularly in the areas of capital risk, market risk, and operational risk, ensuring that financial institutions maintain sufficient capital to absorb unforeseen losses.

Basel is a city in Switzerland where the headquarters of the Bank for International Settlement (BIS) is located. BIS fosters cooperation among Central Banks with a common goal of financial stability and common standards of banking regulations.

Key Points

- Basel Accords set capital requirements and risk measurements for global banks.
- Financial institutions must maintain enough capital to meet obligations and absorb unforeseen losses.
- Basel III, the latest accord, mandates a minimum common equity and liquidity ratio for banks.

Understanding the Basel Accords

Developed since the 1980s, the BCBS was founded in 1974 to enhance global financial stability through improved banking supervision. Basel I, initiated in 1988, focused on capital adequacy, categorising assets into risk categories. Basel II updated the accord, introducing three pillars and dividing regulatory capital into three tiers. Basel III, established in 2010 after the 2008 financial crisis, strengthened the accords with additional requirements and eliminated tier 3 capital.

Basel I

Issued in 1988, Basel I addressed capital adequacy by categorising assets into risk percentages. Banks operating internationally must maintain capital (Tier 1 and Tier 2) at 8% of risk-weighted assets to meet obligations.

Having main thrust on credit risks of banks, they basically refer to the following four pillars:

- Elements of Capital (includes Tier-1 and Tier-2 Capital)
- System of Risk Weighting (includes five weights: 0%, 10%, 20%, 50%, and 100%)
- Basel Capital Adequacy Ratio
- Arrangements regarding implementation

Basel II

Known as the Revised Capital Framework, Basel II updated the original accord with three pillars focusing on capital requirements, supervisory review, and market discipline. The eligible regulatory capital was divided into three tiers, with tier 3 capital later rescinded under Basel III. Following three pillars were considered in:

- **Minimum Capital Requirements** (includes weighted risks and expanded capital requirements)
- **Market Discipline** (includes transparency and accountability dimensions)
- **Supervisory Review** (includes regulatory intervention guided by a set of four principles)

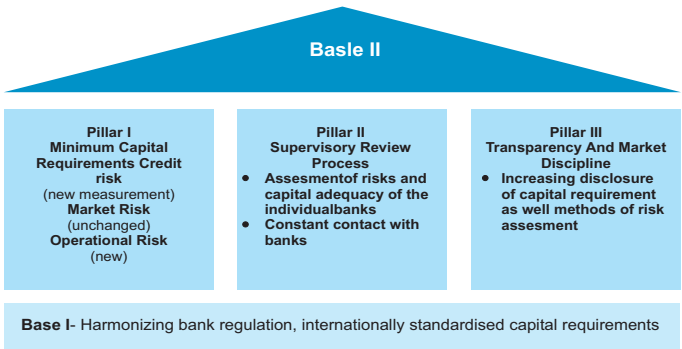


Fig. 8.6: Basle II

Basel III

Established in 2010 after the Lehman Brothers collapse, Basel III strengthened the accords, requiring banks to maintain minimum common equity and a liquidity ratio. It eliminated tier 3 capital and integrated reforms into the consolidated Basel Framework. **Basel 3.1 or Basel IV** includes phase-in provisions starting in 2023, referred to as measures beyond Basel III.

The 3 main pillars of Basel III are given below:

- Minimum Capital Requirements
- Leverage Ratio
- Liquidity Requirements

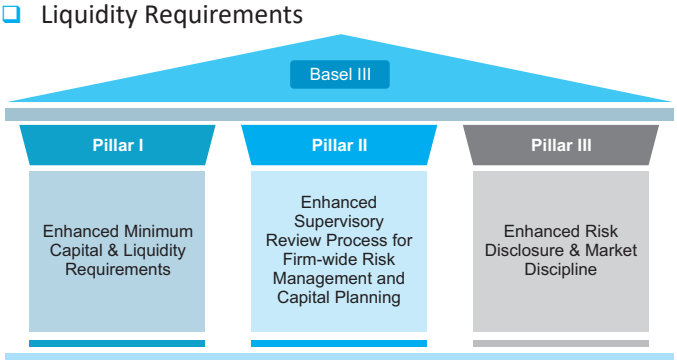

Basel III
Pillar I
Pillar II
Pillar III
Enhanced Minimum Capital & Liquidity Requirements
Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning
Enhanced Risk Disclosure & Market Discipline

Fig. 8.7: Base III

Pillars of Basel III

Capital:

- Maintaining a capital adequacy ratio of 12.9 percent is crucial.
- The minimum Tier 1 and Tier 2 capital ratios should be upheld at 10.5 percent and 2 percent of risk-weighted assets, respectively.
- Additionally, banks are required to uphold a capital conservation buffer of 2.5 percent.
- The counter-cyclical buffer should be maintained within the range of 0-2.5 percent.

Leverage:

- Ensuring a leverage rate of at least 3% is imperative.
- The leverage rate is determined by the ratio of a bank's tier-1 capital to the average of total consolidated assets.

Funding and Liquidity:

Basel-III has established two liquidity ratios: LCR and NSFR.

- The **Liquidity Coverage Ratio** (LCR) necessitates banks to maintain a buffer of high-quality liquid assets sufficient to address cash outflows during acute short-term stress scenarios, as specified by regulators.
- This precautionary measure aims to prevent situations akin to a "Bank Run," ensuring that banks possess adequate liquidity to withstand a 30-day stress scenario if it arises.
- The **Net Stable Funds Rate** (NSFR) mandates that banks uphold a consistent funding profile concerning their off-balance-sheet assets and activities.
- Banks must fund their operations with stable sources of funding that are reliable over a one-year horizon, and the NSFR should be no less than 100 percent.

Capital Adequacy Ratio

The capital adequacy ratio (CAR) is a crucial indicator of a bank's financial health. It measures the bank's ability to withstand potential losses by comparing its capital (financial resources) to its risk-weighted assets (the amount of money it has loaned out or invested in assets with varying risk levels). Here's a breakdown of the key aspects of CAR:

Formula: CAR = (Tier 1 Capital + Tier 2 Capital)/Risk-Weighted Assets

- **Tier 1 Capital:** Core capital that includes equity, retained earnings, and certain types of hybrid instruments.
- **Tier 2 Capital:** Supplementary capital that can include subordinated debt and certain types of reserves.
- **Risk-Weighted Assets:** Assets assigned weights based on their perceived riskiness. Loans to uncreditworthy borrowers, for example, have higher weights than government bonds.

Importance of CAR

- **Protecting depositors:** A higher CAR indicates the bank has a larger buffer to absorb potential losses, safeguarding depositors' money.
- **Promoting financial stability:** A strong banking system with adequate capital levels helps prevent bank failures and systemic financial crises.
- **Leveling the playing field:** Minimum CAR requirements ensure fair competition between banks by requiring them to hold sufficient capital.

Regulatory Requirements

- **Basel Accords:** International regulations like Basel III set minimum CAR requirements for banks.
- **National regulations:** Each country may have its own additional CAR requirements specific to its financial system. In India, the RBI requires banks to maintain a CAR of 9%.

Impact of CAR

- A higher CAR can limit a bank's lending capacity as it needs to hold more capital.
- A lower CAR can increase a bank's risk profile and make it more vulnerable to potential losses.
- Finding the right balance between capital adequacy and lending growth is a key challenge for bank regulators and policymakers.

Basel III Capital Framework Portfolios For All India Financial Institutions (AIFIs)

The Reserve Bank of India (RBI) has introduced regulations regarding the Basel III capital framework, fundraising, exposure guidelines, and the classification and valuation of investment portfolios for All India Financial Institutions (AIFIs). These regulations are scheduled to be implemented from April 2024.

In India, five AIFIs are under the regulatory purview of the central bank.

These institutions include the Export-Import Bank of India (EXIM Bank), the National Bank for Agriculture and Rural Development (Nabard), the National Bank for Financing Infrastructure and Development (NaBFID), the National Housing Bank (NHB), and the Small Industries Development Bank of India (SIDBI).

Implementation of Basel III in India

The Basel III accords are to be implemented in India in a phase-wise manner from April 1, 2013 to March 31, 2019 in the light of the guidelines issued by Reserve Bank of India in May 2012 to attain sustainability on micro as well as on macro level.

Basel III reforms are aimed at strengthening the regulatory norms at bank-level or we can say the micro-prudential regulation, to raise the resilience of individual banking institutions in periods of stress.

The Basel III Capital Regulations Guidelines Issued by RBI have Six Constituents

- Minimum Capital Requirements
- Supervisory Review and Evaluation Process
- Market Discipline
- Capital Conservation Buffer Framework
- Leverage Ratio Framework
- Countercyclical Capital Buffer Framework

IGNITE YOUR MIND

Do you think the Basel Accords, particularly Basel III, have significantly strengthened the resilience of Indian banks and enhanced the stability of the financial system? How can the implementation of Basel III be balanced to ensure both regulatory compliance and support for lending growth?

COMMITTEES RECOMMENDATIONS

PJ Nayak Committee(2014)

Key Recommendations

- **Ownership Reforms:** Suggested reducing government stake in Public Sector Banks (PSBs) to below 50% to professionalise governance.
- **Bank Board Restructuring:** Advocated a significant overhaul of bank boards by allowing a majority of independent directors.
- **PSBs Autonomy:** Emphasized enhancing autonomy and minimising government intervention in PSB functioning.
- **Recapitalization Mechanism:** Proposed a mechanism for efficient recapitalization of PSBs, reducing reliance on government funds.
- **Asset Quality & NPAs:** Called for stricter norms in managing Non-Performing Assets (NPAs) and suggested creating a Public Credit Registry.
- **Prudential Norms:** Recommended the implementation of strong prudential norms aligned with global standards.

Impact

- Several PSB mergers have taken place, creating larger and more robust banks.
- Capital adequacy ratios of PSBs have improved over time.
- Governance reforms have led to more professional boards and risk management practices.
- Technology adoption has increased, but further progress is needed.

Narasimham Committee (1991 & 1998)

Key Recommendations

- **Banking Sector Reforms:** Stressed on liberalization, entry of private sector banks, and reduction of government intervention.
- **Capital Adequacy:** Emphasized the adoption of Basel norms and enhancement of the capital adequacy ratio.
- **Regulatory Framework:** Focused on strengthening the regulatory framework and autonomy of regulators.
- **Priority Sector Lending:** Advocated for enhancing credit to the priority sector while revisiting norms.
- **Asset Quality & NPAs:** Stressed the need for stringent measures to manage NPAs and improve asset quality.

Impact

- Interest rates have been largely decontrolled, leading to more efficient allocation of resources.
- Risk-based supervision and capital adequacy norms have strengthened the banking system's stability.
- Private and foreign banks have entered the market, increasing competition and product offerings.
- Technology adoption has improved, but digital divide and cybersecurity remain challenges.

Comparison Between The Two Committees

Feature	PJ Nayak Committee	Narasimham Committee
Focus	Public Sector Banks	Overall Banking System
Objective	Strengthening and reforming PSBs.	Introducing market-driven reforms.
Key Recommendations	Consolidation, capital adequacy, governance, HR, technology.	Liberalization, prudential regulation, new players, technology.
Impact	Merged PSBs, improved capital, better governance, talent management.	De-controlled interest rates, risk management, competition, technology adoption.

Systemically Important Financial Institutions

Systemically Important Financial Institutions (SIFIs) are banks, insurance companies, or other financial institutions whose failure could trigger a financial crisis and destabilise the entire financial system. Their critical role in the economy and potential for widespread disruption earns them heightened regulatory scrutiny and oversight.

The regulation of these entities falls under the purview of different regulatory bodies. Banks are regulated by the Reserve Bank of India (RBI), and NBFCs are regulated by RBI, SEBI, or IRDA. These regulatory bodies declare certain institutions as Systemically Important.

- **RBI** designates banks with an asset size exceeding 2% of the GDP as Domestically Systemically Important Banks (DSIBs). The list of DSIBs is declared annually, with institutions like SBI, HDFC, and ICICI currently classified as DSIBs.
- Similarly, RBI designates Domestic Systemically Important NBFCs if their asset size exceeds ₹ 500 crores.

- **IRDAI** identifies Domestic Systemically Important Insurers (D-SIIs) based on the value of assets under management and premium underwritten. For 2020-21, LIC, GIC, and NIAC have been declared as D-SIIs.
- **SEBI** designates Domestically Systemically Important Financial Market Infrastructures (FMIs) such as commodity exchanges MCX and NCDEX.

Banking Sector: Governance / Administrative Reforms

1. Personnel Selection: FSIB Replacing BBB (2022)

- The Banks Board Bureau (BBB) was established in 2016 to recommend appointments for whole-time directors (WTDs) and non-executive chairmen (NECs) in public sector banks (PSBs) and other financial institutions (FIs).
- However, criticisms arose regarding delays in appointments, lack of transparency, and concerns about the BBB's competence in selecting directors for insurance companies.
- To address these shortcomings, the government established the Financial Services Institutions Bureau (FSIB) in April 2022.
- FSIB takes over the BBB's role in recommending appointments for WTDs and NECs in:
  - PSBs
  - Public sector insurance companies (PSICs)
  - Financial institutions like NABARD, SIDBI, and EXIM Bank.

Key Changes

- **Streamlined Appointments:** FSIB aims to expedite the recruitment process, aiming to complete selections within 120 days.
- **Enhanced Transparency:** Clearer selection criteria and a more comprehensive search process are intended to increase transparency.
- **Wider Candidate Pool:** FSIB can draw from a broader pool of talent, including professionals from the private sector.
- **Improved Governance:** FSIB has a more diverse board with independent members and expertise in various sectors.

Impact

- Faster and more transparent appointments can improve the governance and performance of PSBs and FIs.
- Attracting talent from diverse backgrounds can bring fresh perspectives and innovation to the financial sector.
- Enhanced trust in the selection process can boost investor confidence and stability in the financial system.

2. PSB Banking Personnel Reforms: Insights from Economic Survey 2020

- **Enhanced Personnel Framework:** Proposed to elevate the capabilities and efficiency of banking personnel within Public Sector Banks (PSBs).

Key Recommendations

- **Performance-Based Appraisals**
  - Advocate for introducing performance-based evaluations to enhance workforce efficiency.
  - Suggested linking promotions and rewards to employees' performance metrics.
- **Specialized Training Programs**
  - Emphasize specialized training modules to augment skill sets and competence.
  - Proposed domain-specific training to cater to evolving banking needs.
- **Flexible Staff Policies**
  - Suggested flexible policies catering to staffing needs, particularly in digital banking and technology-related roles.
  - Encouraged PSBs to adopt flexible hiring and staffing policies for optimal resource utilization.
- **Digital Literacy Initiatives**
  - Advocated for comprehensive programs to bolster digital literacy among banking staff.
  - Emphasized the importance of enhancing technological capabilities among employees.
- **Innovative Recruitment Strategies**
  - Proposed innovative recruitment strategies to attract young talent, especially in technology-driven roles.
  - Encouraged partnerships with educational institutions for talent acquisition.
- **Leadership Development Programs**
  - Stressed the implementation of leadership development programs to nurture future banking leaders.
  - Recommended mentorship programs to facilitate knowledge transfer and skill enhancement.
- **Focus on Employee Well-being**
  - Highlighted the importance of employee well-being initiatives, including stress management programs and health benefits.
  - Advocated for work-life balance programs to boost employee satisfaction and productivity.

Expected Impact

- **Augmented Efficiency:** Anticipated improvement in operational efficiency and service quality.
- **Talent Attraction and Retention:** Enhanced strategies to attract and retain top talent.
- **Technological Uptake:** Focused efforts to enhance digital skills and technology adoption among banking staff.
- **Leadership Cultivation:** Development of strong leadership pipelines for future banking roles.
- **Employee Satisfaction:** Initiatives to improve work environments and overall employee satisfaction levels.

3. Enhanced Access and Service Excellence (EASE) Agenda 2018

In a significant move to revamp and reinvigorate the banking sector, the Indian government and Public Sector Banks (PSBs) joined forces to launch the Enhanced Access and Service Excellence (EASE) Reform. Introduced in January 2018, this transformational initiative is aimed at modernising PSBs, driving growth, and improving their performance across various facets.

Understanding the Stages of EASE

EASE has evolved through various iterations, each focusing on specific areas for improvement:

- **EASE 1.0:** Focused on transparently resolving Non-Performing Assets (NPAs), showcasing significant progress in this crucial area.
- **EASE 2.0:** Built upon the foundation of EASE 1.0, focusing on solidifying reforms, strengthening processes, and driving outcomes across six key themes. Responsible banking, customer responsiveness, credit off-take, MSME support, financial inclusion & digitalization, and governance & HR.
- **EASE 3.0:** Emphasized enhancing customer experience through technology. Initiatives like Dial-a-loan, PSBloansin59minutes.com, partnerships with FinTechs and E-commerce companies, and tech-enabled agriculture lending aimed to simplify and expedite banking access.
- **EASE 4.0:** Pushed for tech-driven, collaborative banking with a focus on 24x7 banking, North-East development, creating a Bad Bank, raising funds outside the banking sector, and leveraging the Fintech landscape.
- **EASE 5.0:** The current iteration focuses on evolving to meet changing customer needs and compete in a dynamic technological environment. Digital customer experience, integrated and inclusive banking, and support for small businesses and agriculture are key priorities. Additionally, PSBs will undertake initiatives across diverse themes like business growth, profitability, risk, customer service, operations, and capability building.

EASE has yielded positive results in several areas, including increased financial inclusion, improved customer service, and enhanced operational efficiency. However, challenges remain, particularly in bridging the digital divide, achieving commercial viability for PSBs, and attracting and retaining skilled talent.

4. Project Sashakt

- India's banking sector is burdened by bad loans, impacting financial stability and economic growth.
- Project Sashakt, a five-pronged strategy, aims to resolve bad loans and unlock their potential.

Key Features

- **Categorization of bad loans:**
  - Up to ₹ 50 crore: Managed at bank level (90 days deadline).
  - ₹ 50-500 crore: Inter-creditor agreement with lead bank handling resolution (180 days) or referral to NCLT.
  - Above ₹ 500 crore: Transferred to a national Asset Management Company (AMC) supported by Alternative Investment Funds (AIFs).
- **National AMC and AIFs:**
  - **Structure:** Banks contribute to multiple sector-specific AIFs under the AMC.
  - **Function:** These funds buy stressed assets from existing ARCs (Asset Reconstruction Companies), using funds to redeem security receipts issued to banks.
  - **Competition:** Other AMCs, AIFs, and ARCs can bid for assets, matching or exceeding ARCIL's (national AMC) pricing.
  - **Responsibility:** AMC manages operational turnaround of acquired assets.
- **Ownership Transfer:** ARCs transfer ownership of acquired assets to their respective AIFs, with the AMC-AIF holding at **least 76% stake.**

Financial Aspects

- Total value of bad loans above ₹ 500 crore estimated at ₹ 3 trillion.
- AMC expected to require ₹ 1.2 trillion over 6-24 months, with 60-70% coming from domestic sources and 30-35% from foreign investors.

Overall, Project Sashakt presents a comprehensive approach to tackle bad loans, potentially boosting financial stability and unleashing economic potential. The success hinges on effectively implementing the plan, ensuring competitive pricing, and attracting adequate investments.

5. Staff Accountability Framework for PSB-NPA

The Staff Accountability Framework for Public Sector Banks (PSBs) in India, implemented in 2022, addresses a crucial challenge: Non-Performing Assets (NPAs). These are loans that remain unpaid for a specific period, impacting banks' financial health and hindering economic growth. The framework aims to establish clear accountability for NPA creation while protecting bona fide decision-making by bank officials.

Key Features of the Framework

- **Threshold-based approach:** Applies to loan accounts exceeding ₹ 50 crore that turn into NPAs (excluding fraud cases).
- **Focus on decision-making:** Investigates lapses in due diligence, compliance with regulations, and adherence to internal guidelines during loan approval and subsequent monitoring.

- **Risk-graded assessment:** Categorizes NPAs based on severity and assigns responsibility accordingly.
- **Fair and transparent process:** Provides opportunities for officials to defend their actions and present mitigating factors.
- **Proportionate penalties:** Imposes appropriate disciplinary measures ranging from warnings to dismissal, considering the level of culpability and potential impact on the bank.

Potential Benefits

- **Reduced NPA creation:** Increased accountability discourages risky lending practices and encourages stricter due diligence.
- **Improved loan recovery:** Prompt corrective action and early identification of potential NPAs can facilitate faster recoveries.
- **Enhanced financial stability:** Lower NPAs strengthen PSBs' balance sheets and boost lending capacity.
- **Fostering a culture of prudence:** Clear guidelines and transparent accountability promote responsible decision-making among bank officials.

Challenges and Considerations

- **Balancing accountability with protection:** Striking a balance between holding officials accountable and safeguarding against undue harassment is crucial.
- **Operational complexity:** Implementing the framework effectively requires robust systems, trained personnel, and efficient grievance redressal mechanisms.
- **Potential for subjectivity:** Ensuring fair and consistent application of the framework across different cases and situations is essential.

IGNITE YOUR MIND

The Basel Norms, developed by the Basel Committee on Banking Supervision, are international regulatory standards that aim to enhance the stability and integrity of the global banking system. What are the key challenges faced by India in implementing and adhering to the Basel norms, considering that India is still a developing economy and that banks are an immense source of credit generation to keep the wheel of economy running?

Loans

- Loans are financial instruments provided by financial institutions, including banks and non-banking financial companies (NBFCs), to individuals, businesses, or entities in need of funds.
- In the bustling world of finance, loans and advances serve as fuel for individuals, businesses, and organizations to pursue their goals. Offered by banks and financial institutions, these financial products allow borrowers to obtain money for various purposes, from buying a house to investing in a business venture.
- **Interest Rates:** When you take out a loan, you agree to pay back the principal amount (the sum borrowed) along with interest, a fee for borrowing the money. Interest rates can be either fixed, remaining constant throughout the loan term, or floating, fluctuating based on market conditions or a benchmark rate.
- **Bank Assets:** From a bank's perspective, loans and advances are valuable assets. As borrowers repay the principal and interest, the bank generates income, strengthening its financial position. However, not all loans perform as expected.

Loan Classification: Based on The Borrower's Repayment Behavior, Loans are Categorized as

- **Standard Assets:** These are loans where borrowers are making regular and timely payments of both principal and interest, as per the loan agreement. These are the ideal scenario for banks, ensuring a steady stream of income.
- **Non-Performing Assets (NPAs):** When borrowers consistently miss or delay payments, their loan enters the realm of NPAs. This poses a significant risk to the bank as it affects their financial stability and profitability.

Types of Loans

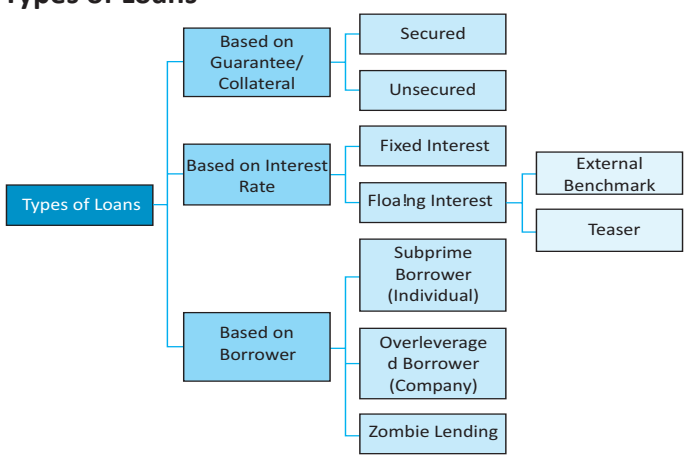


Fig. 8.8: Types of Loans

The Diverse World of Loans Offers Options For Various Needs and Circumstances. Here are Some Common Types

- **Personal Loans:** Used for personal expenses like debt consolidation, education, or medical bills.
- **Home Loans:** Help individuals or families purchase houses or apartments.
- **Auto Loans:** Finance the purchase of vehicles like cars, motorcycles, or even boats.
- **Business Loans:** Provide capital for businesses to start, expand, or invest in projects.

- **Student Loans:** Assist students in financing their education.

Related Terminology

- **Special mention accounts (SMA):** Assets that require special attention due to early signs of credit risk. It is a stage before an Asset is considered as NPA. It is divided into three categories: SMA-1, SMA-2, and SMA-3, with classification based on the duration of loan repayment overdue, ranging from **0 to 90 days.**
- **Haircut:** Reduction or adjustment made to the value of a loan to make it feasible to repay during stressed financial circumstances.
- **Teaser loans** are loans where borrowers are initially offered loans with highly favourable terms, such as low interest rates, for an introductory or "teaser" period to entice borrowers to take out the loan. However, after the teaser period expires, the terms of the loan become less favourable, often resulting in higher interest rates.
- **Interest coverage ratio (ICR):** It is used to assess a company's ability to meet its interest obligations on outstanding debt. ICR indicates how many times a company's operating income covers its interest expenses. A **higher ICR** implies a stronger ability to meet interest payments whereas a low ICR may signal financial risk, indicating that a company's earnings are insufficient to cover its interest costs. **IC1 companies** have an interest coverage ratio less than 1 which indicates that revenues are not sufficient to repay the interest expenses.
- **Provisioning:** Practice of setting aside a portion of a financial institution's earnings or capital to cover potential losses or liabilities that may arise in the future.

Non Performing Assets (NPA)

In the intricate world of banking, loans extended to customers are the lifeblood, the assets that generate income and fuel economic growth. Yet, lurking within this vast ecosystem lies a shadow, a category of assets known as Non-Performing Assets (NPAs). These are loans that have gone rogue, refusing to yield their promised returns, posing a significant threat to the stability of banks and the broader economy.

Simply put, an NPA is a loan or lease that has stalled, failing to deliver its expected flow of interest and principal payments. As per the Reserve Bank of India (RBI), the red flag goes up when such a delinquency stretches beyond 90 days. Imagine it as a borrower who misses their monthly repayments for three consecutive months, triggering the NPA classification.

Categories of NPA Include

- **Sub-standard assets:** These are the youngest NPAs, and delinquents for less than a year. They still harbor a glimmer of hope, potentially amenable to recovery through restructuring or intensive collection efforts.
- **Doubtful assets:** As the name suggests, these NPAs have spent over a year in limbo, their recovery becoming increasingly uncertain. Banks may need to make provisions against these loans, anticipating potential losses.
- **Loss assets:** When recovery efforts prove futile, and the bank or its auditors confirm the irrevocable loss, these NPAs reach their final category. Though not yet written off, they cast a long shadow on the bank's financial health.

Total Stressed Assets = NPAs + Restructured Assets + Written-off Assets

Factors Behind The Rise of Non-Performing Assets in India

The issue of Non-Performing Assets (NPAs) in India casts a long shadow over the banking sector, hampering its health and impacting economic growth. But what fuels this rise in bad loans? Let's delve into the key factors behind this complex problem:

The 2000s Boom and Bust

- **Easy Credit & Over-optimism:** During the economic boom of the 2000s, banks loosened lending norms, chasing aggressive growth targets. This often led to inadequate due diligence and loans granted to companies with shaky financial footing.
- **Infrastructure Focus:** A large chunk of these loans went to infrastructure projects like roads, power, and aviation. However, many projects faced hurdles like:
  - **Delayed Implementations:** Project delays due to bureaucratic inefficiencies and land acquisition issues stretched out timelines and increased costs, impacting borrowers' ability to repay.
  - **Policy Shifts & Regulation:** Changing government policies, red tape, environmental obstacles, and project cancellations threw a wrench into repayment plans, leaving borrowers exposed.

Beyond the Boom

- **The Global Financial Crisis:** The 2008 crisis sent shockwaves through the global economy, impacting sectors like steel and aviation that had received significant loans. This further crippled their repayment capacity and contributed to NPA woes.
- **Corporate Mismanagement & Fraud:** In some cases, poor corporate governance, mismanagement of funds, and even loan diversion tactics by borrowers exacerbated the NPA problem.

A Multifaceted Challenge

The rise of NPAs is not a single-dimensional issue; it's a complex web of factors woven together:

- **Inadequate Risk Management:** Weak credit appraisal processes and lax monitoring by banks left them vulnerable to defaults.
- **External Pressures:** Policy uncertainties, regulatory hurdles, and economic slowdowns can create conditions that even well-intentioned borrowers struggle to navigate.
- **Information Asymmetries:** Sometimes, banks lack complete information about a borrower's true financial health, leading to miscalculations and unexpected defaults.

NPA as % of Total Loans Given by Scheduled Commercial Banks (SCBs)

2017	2021	2022
11%	7%	5%

Effects of NPAs on Economy

- Shortage of funds in the Indian economy as banks refrain from extending new credit.
- Rising Interest rates by banks to sustain profitability(Spread) .
- Bank failures due to rise (NPAs) and declining profitability as seen in the case of IL&FS, DHFL, Laxmi Vilas bank (LVB).
- Twin balance sheet challenge where banks are under severe stress and the corporates are overleveraged to the extent that they cannot repay their loans.
- Rise in unemployment due to limitations on further investment.
- In the end, the increase in NPAs contributes to a downward spiral involving reduced economic growth and high inflation.

Spread: It is the profit a bank earns from the difference between the interest it pays to depositors and the interest it charges borrowers.

Gross NPA: It refers to the total value of loans or assets that have become non-performing, meaning that the borrowers have defaulted on their payments or the assets have stopped generating income.

Net NPA: Net NPAs are determined by deducting the provisions allocated for bad loans (referred to as loan loss provisions) from the overall Gross NPAs. In other words, it represents the portion of non-performing assets that have not been adequately provisioned for by the bank.

Wilful Defaulter: It refers to a borrower who intentionally and knowingly defaults on a loan obligation despite having the financial capacity to repay.

Government-Initiated Measures For Addressing The NPA Crisis

Corporate Debt Restructuring (CDR) 2001	Allowed banks to restructure debt by lowering principal or interest rate or by extending tenure for stressed corporate borrowers
SARFAESI Act 2002	Empowered institutions to take possession of collateral and sell assets without court intervention.
Debt Recovery Tribunals (DRTs)	Established under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, to expedite the recovery of NPAs without being subjected to lengthy process of civil courts.
Asset Reconstruction Companies (ARCs)	Engaged in acquiring NPAs from banks and try to resolve them.
5/25 Scheme (2014)	Allowed banks to extend the repayment period for long-term projects to 25 years, with Interest rates reviewed every 5 years.
Strategic Debt Restructuring (SDR) 2015	Allowed conversion of debt into equity and take over the management of the distressed firms.
Asset Quality Review (2015)	To assess the bank's overall asset quality; identifies potential hidden or undisclosed non-performing assets.
Sustainable Structuring of Stressed Assets (S4A) 2016	Banks can hire an independent agency to determine the viable debt for a company, converting the unviable portion into equity.
Insolvency and Bankruptcy Code (IBC), 2016	Time-bound resolution process for both corporations and individuals by creating a single law for insolvency and bankruptcy.
K.V. Kamath committee	The committee looked into Restructuring of loans impacted by the Covid-19 pandemic.

Prudential framework for resolution of stressed assets (2019)	Replaced the earlier schemes (CDR,S4A,SDR etc) and provided a more structured and time-bound approach; Made Voluntary for lenders to take defaulters to the Bankruptcy court through IBC 2016.
NARCL and IDRCL (2021)	National Asset Reconstruction Company Ltd.(NARCL) and India Debt Resolution Company ltd. (IDRCL) as asset management companies.
Mission Shashakt	To enable the resolution of NPAs through a cooperative approach involving both banks and government agencies.

Asset Reconstruction Company (ARC)

Non-Performing Assets (NPAs) have long been a thorn in the side of India's banking sector, impacting its health and hindering economic growth. To address this challenge, Asset Reconstruction Companies (ARCs) emerged as a key solution, offering banks a way to clean up their balance sheets and focus on core banking activities.

The ARC Story

- **Narasimham Committee recommendations (1998):** Recognizing the growing NPA problem, the Narasimham Committee proposed the establishment of an ARC dedicated to purchasing bad loans from banks.
- **SARFAESI Act 2002:** This act paved the legal framework for setting up multiple private ARCs, empowering them to acquire and resolve stressed assets through negotiation, restructuring, or asset sale.
- **Government's push for ARCs:** Recognizing the potential of ARCs, the government recently proposed setting up ARCs by both state-owned and private sector banks, without any government equity contribution. This aims to address the problem of high provisioning requirements for stressed assets faced by public sector banks and effectively function as a "bad bank" for India.

ARCs in Action

- **Acquiring NPAs:** ARCs negotiate with banks to purchase NPAs at a discounted value, freeing up banks' capital and resources.
- **Resolution strategies:** ARCs employ various strategies to resolve the acquired assets, including:
  - **Debt restructuring:** Renegotiating payment terms with the borrower to improve repayment prospects.
  - **Asset monetization:** Selling off assets associated with the loan to generate recoveries.
  - **Turnaround management:** Implementing operational improvements to revive distressed businesses.
- **Focus on core banking:** By offloading NPAs to ARCs, banks can refocus their efforts on lending to viable businesses and supporting economic activity.

Challenges and the Road Ahead

While ARCs offer promising solutions, some challenges remain:

- **Operational complexities:** Efficient acquisition, resolution, and exit strategies are crucial for ARCs' success.
- **Legal hurdles:** Legal disputes and delays in recovery processes can hinder timely resolution.
- **Valuation issues:** Accurately valuing stressed assets is crucial for both ARCs and banks.

Despite these challenges, the government's commitment to ARCs and the recent regulatory initiatives suggest a promising future. Continued efforts to streamline processes, refine resolution strategies, and enhance legal frameworks are crucial for maximizing ARCs' effectiveness in tackling India's NPA problem

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, better known as the SARFAESI Act, serves as a powerful weapon in the Indian banking sector's arsenal against the persistent foe of Non-Performing Assets (NPAs). This act empowers banks and financial institutions to efficiently recover bad loans, ultimately strengthening the financial system and boosting economic growth.

Key Features of The SARFAESI Act

- **Enhanced Power to Banks:** SARFAESI grants banks the authority to directly take possession of secured collateral assets (like land, property, shares) in case of loan defaults, bypassing lengthy court proceedings.
- **Fast-Track Resolution:** This act establishes Debt Recovery Tribunals (DRTs) and Debt Recovery Appellate Tribunals (DRATs) specifically for speedy resolution of loan recovery cases, offering an alternative to the overburdened regular courts.
- **Asset Reconstruction Companies (ARCs):** SARFAESI facilitates the establishment of ARCs, specialising in acquiring distressed assets from banks and managing their resolution through restructuring, sale, or other strategies.
- **Deterrence against Defaults:** The swift and decisive action enabled by SARFAESI acts as a deterrent against willful loan defaults, promoting a culture of responsible borrowing and lending.

Applicability and Exemptions

While widely applicable to various banks and loans, SARFAESI has its limitations:

- **Secured Loans Only:** It applies solely to loans secured by collateral, not unsecured loans like personal loans or credit cards.

- **Minimum Loan Amount:** Loans below Rs. 1 lakh and those where the remaining debt is less than 20% of the original principal fall outside its scope.
- **Exceptions:** Agricultural loans, certain specialised loans like education loans, and loans granted by non-financial entities are also exempt.

Overall Impact

The SARFAESI Act has made a significant impact on the Indian banking landscape:

- **Reduced NPAs:** The act has contributed to a decrease in NPA levels, freeing up bank capital for lending and growth.
- **Improved Risk Management:** Enhanced powers and swift recovery mechanisms encourage prudent lending practices and risk management by banks.
- **Strengthened Financial System:** A healthier banking sector with lower NPAs fosters increased economic activity and investor confidence.

Fig. 8.9

Limitations of SARFAESI Act

- **Limited Applicability:** Act applies only to secured loans leaving an array of financial products out of its scope.
- **Potential for Misuse:** Critics argue that the banks might exploit it to place unwarranted pressure on borrowers, particularly those who are small and financially vulnerable.
- **Shortage of staff:** DRT and DRAT are understaffed, which led to a high pendency of cases.
- **Asset Valuation Issues:** The act does not prescribe a specific methodology for valuing assets, which will lead to legal complications and delays in resolution.
- **Challenges in Selling Distressed Assets:** Distressed assets are difficult to sell, especially when the collateral consists of specialized assets.This could further get aggravated when the economy is facing a downturn.
- **No provision for Restructuring:** Restructuring can enhance the value for banks in certain cases
- **Potential Moral Hazard:** Banks may be more willing to extend loans without due diligence if they believe they can easily recover their funds through the act's provisions.
- **Impact on Borrower's Creditworthiness:** The recovery process can negatively impact a borrower's creditworthiness, making it difficult for them to access credit in the future.

Securitisation: It is the process in which assets like loans, mortgages etc are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.

Security Interest: It refers to a legal right that a creditor holds in a borrower's property or assets which are used as collateral to secure the debt. This interest can be used to recover the debt if the borrower defaults on their repayment obligations.

The Insolvency and Bankruptcy Code (IBC) 2016

- The Insolvency and Bankruptcy Code (IBC) in India is a comprehensive legal framework designed to consolidate and streamline laws and regulations concerning insolvency and bankruptcy.
- Its primary aim is to establish a creditor-driven and time-bound process, enhancing the credit culture and business atmosphere in the country.
- It applies to all types of business entities including corporate entities, partnerships firms, limited liability partnerships, individuals
- India did not have a unified bankruptcy code. It was relying on archaic and conflicting laws. Absence of modern insolvency and bankruptcy code proved costly for the creditors especially banks as seen in the recent Kingfisher Airlines case. The Insolvency and Bankruptcy Code seeks to create a coherent framework to resolve insolvency and bankruptcy in India.

Need of The Code

- **Lack of unified code:** It replaces archaic laws such as the Presidency Towns Insolvency Act, 1909 and creates a single framework.
- **Lack of one stop solution:** Multiple legal avenues like High Courts and the Company Law Board for resolution created conflicts, overlaps, and delays.
- **Delays and pendency of cases:** Delays diminishes the value of the assets, making the insolvency negotiations ineffective.
- **Lack of time bound resolution:** According to the World Bank, the process of winding up a financially troubled company in India takes over four years, nearly double the duration compared to that in China.

Features of Insolvency and Bankruptcy Code (IBC)

- **Time-Bound Resolution:** The IBC mandates a time-bound resolution process to facilitate the timely and efficient handling of insolvency cases.
- **Creditors' Committee:** It establishes a committee of creditors to make critical decisions related to insolvency resolution, ensuring the participation of creditors in the process.

- **Insolvency Professionals:** Qualified insolvency professionals play a pivotal role in managing the insolvency process, overseeing the resolution, and protecting stakeholders' interests.
- **Clear Hierarchy for Resolution:** The IBC establishes a clear hierarchy for the distribution of assets in case of insolvency, providing priority to creditors in a predefined order.
- **Liquidation as Last Resort:** It emphasizes resolution over liquidation, aiming to preserve the value of the distressed company rather than resorting to its closure and liquidation.

Performance

- **Increased resolution volume:** IBC has facilitated the resolution of thousands of cases, leading to significant recovery for creditors.
- **Faster resolution timelines:** While the 365-day target remains elusive, cases are generally resolved faster than pre-IBC regimes.
- **Improved debt recovery:** Average recovery rates have improved compared to pre-IBC systems.
- **Enhanced transparency and accountability:** Clearer processes and disclosures bring greater transparency to the resolution process.
- **Challenges remain:** Delays in litigation, complex legal issues, and lack of adequate infrastructure present ongoing challenges.
- **Impact on specific sectors:** Real estate and infrastructure sectors have seen significant activity under the IBC, while other sectors like MSME face unique challenges.

Overall, the IBC has brought significant reforms to India's insolvency resolution framework, promoting transparency, efficiency, and accountability in dealing with distressed assets and companies.

Wilful Defaulter

A wilful defaulter refers to a borrower or an entity that has deliberately chosen not to repay a loan despite having the financial capacity to do so. This classification is not merely for those facing genuine financial hardship but for those who intentionally avoid repayment despite having the means to honor their obligations.

Key Characteristics of A Wilful Defaulter

- **Intentional Non-Payment:** They possess the financial means to repay the loan but deliberately refuse to do so.
- **Misuse of Funds:** The borrower may have diverted the funds availed through the loan for purposes other than what the loan was originally intended for.
- **Discrepancy in Use of Funds:** There's evidence that the borrower used the funds for purposes other than what was agreed upon or specified in the loan terms.
- **Non-Cooperation with Lenders:** They fail to provide necessary information sought by the lender or hinder the lender's efforts to assess the borrower's financial position.
- **Misrepresentation or Fraud:** They may have provided false information or misrepresented their financial position to obtain the loan.
- **Defaulter Classification:** Banks or financial institutions classify entities as wilful defaulters based on specific criteria and after providing them with an opportunity to explain their position.

Consequences of Being Declared A Wilful Defaulter

- **Restriction on access to credit:** Wilful defaulters face severe restrictions on accessing further credit from banks and financial institutions.
- **Higher interest rates:** Even if they do manage to obtain credit, it will likely be at significantly higher interest rates due to the increased risk perception.
- **Legal action:** Lenders can initiate legal proceedings to recover the outstanding dues, which may lead to asset seizures, bankruptcy, or even criminal charges in some cases.
- **Damaged reputation:** The label of "wilful defaulter" can severely tarnish a borrower's reputation in the financial market, making it difficult to do business or secure future investments.

Regulatory Framework In India

- The Reserve Bank of India (RBI) has guidelines for identifying and classifying wilful defaulters.
- Banks are required to report wilful defaulters to the RBI and credit information bureaus.
- The names of wilful defaulters are publicly disclosed on the RBI's website and the websites of credit information bureaus.
- The RBI has also taken steps to strengthen the legal framework for dealing with wilful defaulters, including the introduction of the Insolvency and Bankruptcy Code (IBC).

Deposit Insurance and Credit Guarantee Corporation (DICGC)

- The Deposit Insurance and Credit Guarantee Corporation (DICGC) is an Indian subsidiary of the Reserve Bank of India (RBI) established in 1978 under the DICGC Act, 1961. Its primary role is to provide insurance coverage to depositors in case a bank fails or faces liquidation.
- The DICGC is funded by contributions from member banks. The premium rate is based on the riskiness of the bank's operations.

Objectives of The DICGC Act

1. **Deposit Insurance:** DICGC offers insurance coverage to deposits in all commercial banks, including private, public, foreign, local area, and cooperative banks. Each depositor in a bank is insured up to a specified limit for both principal and interest amounts held in the same right and capacity.
2. **Coverage Limit:** As of now, DICGC insures deposits up to ₹ 5 lakh per depositor in a bank. This coverage extends to all types of deposits, including savings, fixed, current, and recurring deposits.
3. **Coverage Scope:** The insurance coverage extends to the total deposits held by a depositor across all branches of the same bank. If an individual holds deposits in different banks, the coverage limit applies separately to each bank.
4. **Insolvency Coverage:** In the event of a bank failure or liquidation, DICGC steps in to reimburse insured deposits up to the prescribed limit per depositor per bank.
5. **Premiums and Regulations:** Banks are required to pay insurance premiums to DICGC to avail of this coverage. DICGC also regulates banks to ensure compliance with insurance-related guidelines and safeguard depositor interests.
6. **Maintaining Public Confidence:** By providing this safety net, the DICGC Act aims to maintain public confidence in the banking system. This is crucial for financial stability, as it encourages people to deposit their money in banks, which in turn enables banks to lend and support economic growth.
7. **Promoting Financial Inclusion:** The DICGC Act also encourages financial inclusion by providing coverage to deposits in small and rural banks, making banking services more accessible to a wider population.

Limitations of The DICGC Act

1. **Limited Coverage:** The DICGC currently provides insurance coverage up to a maximum of ₹ 5 lakh per depositor per bank. This limit may not be sufficient for larger depositors, especially in cases of joint accounts or multiple deposits.
2. **Not All Deposits Covered:** Certain types of deposits, such as foreign currency deposits, deposits of foreign banks in India, and deposits with cooperative banks (except those specifically notified by the RBI), are not covered under the DICGC Act.
3. **Delayed Claims Settlement:** The process of settling claims in the event of a bank failure can sometimes be delayed due to administrative or legal complexities.
4. **Moral Hazard:** The presence of deposit insurance could potentially lead to moral hazard, where banks may take on excessive risks knowing that depositors are protected.
5. **Financial Burden:** The DICGC is funded by contributions from member banks, which ultimately pass on the cost to depositors. This can place a financial burden on the banking system.

While the DICGC Act plays a significant role in protecting depositors and maintaining financial stability, it is important to acknowledge its limitations and consider potential enhancements. These could include:

- Increasing the coverage limit to align with inflation and economic growth.
- Expanding coverage to include more types of deposits and financial institutions.
- Streamlining the claims settlement process for faster payouts.
- Strengthening risk management and regulatory oversight to mitigate moral hazard.
- Exploring alternative funding mechanisms to reduce the financial burden on banks and depositors.

Bad Bank

- Bad bank refers to a financial institution or entity tasked to **hold and manage distressed or non-performing assets (NPAs)** from other banks or financial institutions.
- The primary purpose of a bad bank is to buy bad loans from banks and remove them from their balance sheets, allowing the parent bank to focus on its core banking activities.
- Typically, Bad Bank is an **Asset Reconstruction Company** (ARC). It does not undertake usual banking operations such as deposit-taking or lending.
- The profit margin comes from the difference between the recovery value and the value at which NPAs are transferred to it.
- The bad bank may sell or restructure the loan to recover the maximum value.

Need/Benefits of The Bad Bank

- **Cleaning up of balance sheet:** Bad bank separates NPAs from a bank's balance sheet which improves its financial picture.
- **Refocus on Core Banking functions:** By alleviating the burden of distressed assets, Banks can refocus their efforts on core banking functions, such as extending loans.
- **Additional lending-** Provisioning for bad loans is released which can be used for additional lending.
- **Risk Management:** By separating NPAs from their balance sheets, Parent banks can reduce their exposure to the credit and market risks linked to those assets.
- Expertise in Asset management- This can lead to a higher recovery value for distressed assets.

- Reduce need of recapitalisation of banks- Bad banks can reduce the need for recapitalization by cleaning up the parent bank's balance sheet and freeing up capital.
- **Market Confidence:** It enhances market confidence in the banking system.

Bad Bank in India

- India's banking sector has long grappled with the burden of Non-Performing Assets (NPAs), posing a significant challenge to financial stability and economic growth.
- To address this issue, the government established **National Asset Reconstruction Company Limited (NARCL) and India Debt Resolution Company Ltd (IDRCL),** often referred to as the "bad bank" twins.

National Asset Reconstruction Company Limited (NARCL)

- NARCL was announced in the **Union Budget 2021-22.**
- It has been incorporated under the Companies Act and works as an Asset Reconstruction Company (ARC).
- NARCL has been set up by banks to aggregate and consolidate stressed assets for their subsequent resolution.
- **Public sector banks hold 51%** ownership in NARCL with **Canara bank as sponsor bank**.
- It will acquire stressed assets of about ₹ **2 Lakh crore** in a phased manner.
- It intends to acquire these through **15% Cash and 85% in Security Receipts** .The SRs issued by NARCL shall be backed by sovereign guarantee of Government of India.

India Debt Resolution Company Ltd (IDRCL)

- IDRCL operates alongside NARCL, specializing in asset management and resolution strategies.
- It engages market professionals and turnaround experts to maximize the value of acquired assets before their eventual sale.
- Public sector banks and institutions hold a maximum 49% stake in IDRCL, while private sector banks control the remaining 51%.

The NARCL-IDRCL Synergistic Approach

- NARCL acts as the acquisition arm, negotiating deals with banks to purchase stressed assets.
- Once acquired, IDRCL takes over, implementing value addition strategies like restructuring, asset monetization, and turnaround plans.
- This collaborative approach aims for faster and more efficient resolution of stressed assets compared to existing mechanisms like ARCs and the Insolvency and Bankruptcy Code (IBC).

Concerns Regarding Bad Bank

- **Effectiveness of the Entity:** Effectiveness of the process is uncertain and may become just another remedy as others available in the market.
- **Asset Valuation:** Determining the fair value of the assets will be a bone of contention between bad bank and parent bank. Also any discounting on the assets is a loss for the bank.
- **High initial cost:** Creating and funding a bad bank requires large capital .
- **Ethical concerns:** Due to unwarranted pressure, Bad bank may employ unethical practices to boost recovery .
- **Lack of trained human resource:** Many existing ARCs are understaffed which reduces their operability.
- **Budgetary pressure:** Capitalising a bad bank or covering its losses may put strain on government finances, which may lead to fiscal deficit.

While a bad bank can be beneficial, it's vital to address the root causes of structural issues in the banking system. Key challenges include minimizing political and bureaucratic influence on public sector banks, promoting professionalism, and adhering to prudent lending practices. In addition to establishing a bad bank, comprehensive banking reforms are necessary.

IGNITE YOUR MIND

Do you think the collaborative approach of NARCL and IDRCL, with one focusing on acquisition and the other on asset management and resolution, provides a more efficient and comprehensive solution to the NPA problem compared to traditional methods?

Steps Taken by RBI

Prompt Corrective Action (PCA)

The Prompt Corrective Action (PCA) framework is a regulatory tool implemented by the Reserve Bank of India (RBI) to address concerns about the financial health of scheduled commercial banks (excluding Regional Rural Banks, Payment Banks, and Small Finance Banks). It aims to identify and address potential problems early on, before they escalate into larger issues.

Key Features of PCA

- **Triggering Points:** The framework identifies specific financial parameters, such as capital adequacy ratio (CAR), non-performing assets (NPAs), and return on assets (ROA), that serve as early warning signals. When a bank breaches predefined thresholds for these parameters, the PCA kicks in.
- **Graduated Approach:** Depending on the severity of the breach, the RBI takes progressively stricter corrective actions. These actions may include:
  - Restrictions on dividend distribution, branch expansion, and investments.
  - Mandatory capital infusion plans.

- Increased supervisory scrutiny.
- Ultimately, in extreme cases, the RBI may even initiate mergers or acquisitions.

❑ **Objectives:** PCA aims to:
- Protect depositors' money.
- Maintain financial stability.
- Promote responsible risk management practices by banks.

Benefits of PCA

❑ **Early intervention:** PCA helps identify and address potential problems early, preventing them from spiraling into larger crises.

❑ **Improved risk management:** The framework incentivizes banks to adopt prudent risk management practices.

❑ **Financial stability:** PCA contributes to a more stable and resilient banking system.

Challenges and Criticisms

❑ **Stringent measures:** Critics argue that the PCA's strict corrective actions can hinder lending and economic growth.

❑ **Discriminatory impact:** Some argue that PCA disproportionately impacts smaller banks with limited capital raising abilities.

❑ **Implementation challenges:** Effective implementation requires strong regulatory capacity and coordination between different stakeholders.

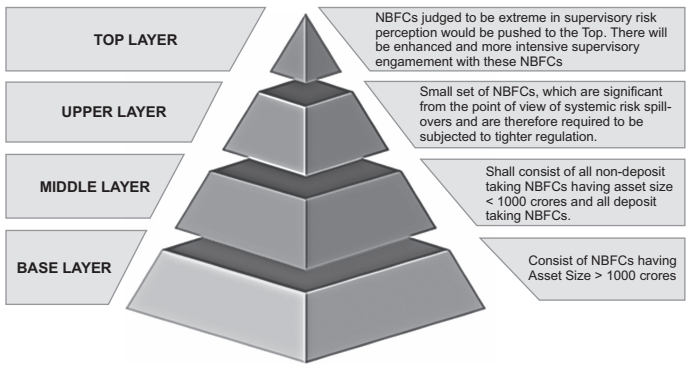


Fig. 8.10

Recently, The Reserve Bank of India has announced that it will **extend the PCA Framework** to government **Non-banking Financial Companies (NBFCs), except those in the base layer (see image below)** with effect from October 1, 2024.

Positive Impacts of Prompt Corrective Action (PCA)	Concerns with Prompt Corrective Action (PCA)
1. Operational performance improvement in Private sector banks (April-June 2018).	1. Negative impact on bank ratings and consumer confidence.
2. Reduction in net losses, enhanced provision coverage ratio, and increased recoveries.	2. Long-term concerns about bank management and its effect on credit history.
3. Adequate capital provided by the government when required.	3. Potential market share loss and decline in the position of Public sector banks.
4. Enables monitoring of bank performance indicators by the Reserve Bank of India.	4. Alleged hindrance to economic growth according to the government.
5. Facilitates calculated measures to restore the financial stability of banks.	5. Advocacy for friendlier lending regulations by the government.
6. Serves as an alert to depositors, investors, and regulators regarding potential issues.	6. Possibility of impacting India's reputation as an investment destination due to conflicts between RBI and the government.

RBI's "3R" Framework: Revitalizing Stressed Assets (2015-2019)

❑ Aimed to address and resolve the mounting issue of stressed assets within the banking sector.

Key Components

Recognition:

❑ **Identification of NPAs:** Required banks to promptly recognize Non-Performing Assets (NPAs) transparently.

❑ **Asset Quality Review (AQR):** Conducted thorough AQRs to uncover and disclose stressed assets accurately.

Resolution

❑ **Stressed Asset Resolution:**
- Encouraged timely and effective resolution of stressed assets.
- Facilitated mechanisms such as Corporate Debt Restructuring (CDR) and Strategic Debt Restructuring (SDR) for resolution.

Recapitalization

❑ **Capital Infusion:**
- Advocated for injecting capital into financially stressed banks.
- Supported through measures like the government's capitalization of Public Sector Banks (PSBs).

Expected Outcomes

❑ **NPA Recognition:** Improved transparency and disclosure of NPAs within the banking sector.

❑ **Resolution Acceleration:** Streamlined processes aimed at faster resolution of stressed assets.

- **Bank Recapitalization:** Strengthened capital bases of banks to better absorb losses and provision for stressed assets.
- **Financial Stability:** Enhanced overall stability within the banking sector by addressing the issue of stressed assets.

RBI's Prudential Framework for Stressed Assets (2019)

The RBI's Prudential Framework for Stressed Assets (2019) represents a significant step in addressing the issue of non-performing assets (NPAs) in India's banking sector. It aims to promote early recognition, prompt resolution, and effective recovery of distressed loans, thereby strengthening the financial health of banks and boosting economic growth.

Key Features

- Stricter provisioning norms: Requires banks to hold higher provisions for NPAs, incentivizing timely action to resolve them.
- Time-bound resolution: Defines specific timelines for resolution based on the severity of NPA categories:
  - 30 days for accounts in default for over 90 days.
  - 180 days for accounts exceeding ₹ 250 crore.
  - 360 days for accounts above ₹ 1000 crore.
- **Enhanced accountability:** Holds bank management accountable for timely resolution with potential consequences for non-compliance.
- **Transparency and disclosure:** Increased transparency in NPA classification and resolution processes to build trust and investor confidence.
- **Principle-based approach:** Provides flexibility for banks to design resolution plans based on specific borrower circumstances and market conditions.

Impact and Benefits

- The framework has led to a decrease in NPA levels and improved provisioning coverage.
- It has encouraged faster resolution of distressed loans, reducing their long-term financial burden on banks.
- Increased transparency and accountability have restored investor confidence in Indian banks.

RBI's KV Kamath Report: Resolution Framework for COVID-Related Stress

- Introduced in response to the economic stress caused by the COVID-19 pandemic.
- Provide a framework for restructuring loans affected by the pandemic, ensuring the continuity of businesses and preventing asset quality deterioration.

Key Components

- **Eligibility Criteria**
  - **Sectoral Parameters:** Criteria based on sector-specific benchmarks for stress recognition.
  - **Financial Parameters:** Criteria considering aspects like Total Outstanding Liability/EBITDA, Total Debt/EBITDA, and Current Ratio.
- **Resolution Framework**
  - **Diagnostic Window:** Lenders to use a 30-day window for assessing the impact of COVID-related stress.
  - **Resolution Plan:** Customized restructuring plans for borrowers facing financial stress due to the pandemic.
- **Operational Guidelines**
  - **Viability Assessment:** Lenders to assess the viability of businesses while devising the resolution plan.
  - **Borrower-Centric Approach:** Provision for borrower-specific resolution plans to align with their financial conditions.
- **Implementation Process**
  - **Independent Verification:** Engagement of external experts for verification of resolution plans for large accounts.
  - **Timely Implementation:** Prompt execution of approved resolution plans within specified timelines.

Framework Applicability

- **Applicability:** Extended to all lending institutions, including banks, NBFCs, and HFCs.
- **Eligible Borrowers:** Businesses affected by the COVID-19 pandemic with stress evident in their financials.
- **Debt Moratorium:** Loans restructured under the framework to be provided with a moratorium period.

Expected Outcomes

- **Financial Revival:** Facilitating businesses' revival through tailored resolution plans.
- **Asset Quality Preservation:** Aims to prevent an upsurge in non-performing assets (NPAs) due to pandemic-related stress.
- **Sustainable Recovery:** Ensures a sustainable and balanced recovery for affected sectors.

Resolution Frameworks 1.0 and 2.0 (2020-21)

As the COVID-19 pandemic swept across the globe, India's banking sector faced a new wave of stress due to loan defaults in various industries. To address this challenge, the Reserve Bank of India (RBI) introduced two temporary frameworks designed to provide relief to borrowers and facilitate quicker resolution of stressed assets:

Resolution Framework 1.0 (August 2020)

- **Targeted Scope:** Applicable to specific loan exposures impacted by the pandemic, including corporate loans, personal loans, and MSME loans.
- **Resolution Tools:** Emphasized restructuring as the primary resolution tool, providing flexibility to modify loan terms like repayment schedules, interest rates, and moratorium periods.

- **Classification Freeze:** Allowed banks to classify eligible stressed exposures as standard assets, preventing automatic downgrades based on technical defaults during the pandemic period.
- **Supervisory Relief:** Offered regulatory concessions like relaxed provisioning norms and capital adequacy requirements to encourage restructuring and prevent immediate write-offs.

Resolution Framework 2.0 (August 2021)

- **Extended Scope:** Incorporated additional loan categories like loans to healthcare and tourism sectors.
- **Enhanced Flexibility:** Streamlined the restructuring process and introduced additional resolution tools like asset sales and securitization.
- **Gradual Normalization:** Defined a roadmap for phasing out classification freeze and supervisory relief measures, emphasizing sustainable resolution over prolonged forbearance.
- **Focus on MSMEs:** Introduced specific restructuring options and eased provisioning requirements for MSME loans.

Both Resolution Framework 1.0 and 2.0 were crucial interventions by the RBI to provide financial relief to borrowers adversely impacted by the COVID-19 pandemic. The frameworks offered a structured approach for lenders to restructure loans, providing flexibility while ensuring timely implementation and reporting. Resolution Framework 2.0 expanded the ambit and relaxed certain norms to adapt to the evolving economic landscape during the pandemic.

Legal Entity Identifier (LEI) Number

The Legal Entity Identifier (LEI) is a **20-character alpha-numeric code** used to uniquely identify parties to financial transactions worldwide. It is used to create a global financial data system that uniquely identifies every legal entity in any jurisdiction that is party to a financial transaction to improve the quality and accuracy of financial data reporting.

It can be obtained from any of the Local Operating Units (LOUs) accredited by the **Global Legal Entity Identifier Foundation (GLEIF)**, the body tasked with the implementation and use of LEI. In India, LEI can be obtained from **Legal Entity Identifier India Ltd. (LEIL)**, which is recognised as an issuer of LEI by the Reserve Bank of India (RBI).

All single payment transactions of ₹ **50 crore and above** undertaken by **entities (non-individuals)** should include remitter and beneficiary LEI information. **Governments** or their Departments are not bound to provide LEI for payment transactions. However, **PSUs**, including those fully owned by the Government, shall need to obtain LEI. It is not required for customer transactions where both remitter and beneficiary are **individuals.**

Some Other Issues in Indian Banking Sector

The banking sector plays a crucial role in facilitating economic activity, but unfortunately, it is not immune to fraud and vulnerabilities. Three major issues – Letters of Undertaking (LoUs), the SWIFT system, and the Nirav Modi scam – highlight some of the complexities and areas requiring improvement within the banking system:

1. Letters of Undertaking (LoUs)

- **What are LoUs?**
  - LoUs are essentially bank guarantees assuring a payment to a beneficiary on behalf of a customer, typically used in trade finance transactions.
- **The Problem:** Misuse of LoUs can lead to significant financial losses, as seen in the case of the Punjab National Bank (PNB) scam involving diamantaire Nirav Modi. The bank issued fraudulent LoUs exceeding $2 billion without proper verification and collateral requirements.
- **Impact:** This incident exposed weaknesses in internal controls, risk management practices, and regulatory oversight within the banking system. It led to financial losses for the bank and impacted investor confidence.

2. SWIFT System

- **What is SWIFT?**
  - The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a global messaging system used for cross-border financial transactions.
- **The Vulnerability:** While secure, SWIFT can be vulnerable to cyberattacks or manipulation as demonstrated in past incidents like the Bangladesh Bank heist. Additionally, reliance on a single centralized system for international financial communication raises concerns about potential vulnerability to geopolitical pressure.
- **The Need:** This highlights the need for enhanced cyber security measures, diversification of messaging systems, and exploring alternative technologies like blockchain for secure and decentralized financial communication.

3. The Nirav Modi Scam

- **The Case:** Nirav Modi, along with his uncle Mehul Choksi, used fraudulent LoUs issued by PNB to obtain credit from various Indian banks. They then fled the country with the borrowed funds.
- **The Fallout:** The scam exposed systemic weaknesses in the banking system, raising concerns about due diligence, internal controls, and collusion between bank officials and fraudsters. It led to significant financial losses for banks and eroded public trust in the banking sector.

These Issues Underscore The Importance of

- Strengthening internal controls and risk management practices within banks.
- Implementing stricter due diligence procedures and collateral requirements for issuing LoUs.
- Enhancing cyber security measures and exploring alternative messaging systems for SWIFT.

- Improving regulatory oversight and coordination between banks and law enforcement agencies.
- Promoting transparency and accountability within the banking sector.

Financial Messaging Systems

Financial messaging systems are the backbone of global financial transactions, enabling the secure and efficient exchange of information between banks and other financial institutions. One of the most prominent messaging systems is the Society for Worldwide Interbank Financial Telecommunication (SWIFT).

SWIFT

- Established in 1973, SWIFT is a cooperative owned by its members, which include over 11,000 financial institutions in more than 200 countries and territories.
- It provides a secure and standardized platform for banks to exchange information about cross-border payments, trade finance, and other financial transactions.
- SWIFT messages are encrypted and routed through a secure network, ensuring the confidentiality and integrity of the information they contain.

SWIFT Ban on Russia

- In February 2022, following Russia's invasion of Ukraine, several Western countries, including the United States and the European Union, imposed sanctions on Russia. These sanctions included the removal of certain Russian banks from the SWIFT system.

Impact of the SWIFT Ban

The SWIFT ban has significantly impacted Russia's financial system in several ways:

- Russian banks that are excluded from SWIFT cannot send or receive international payments through the system, making it difficult for them to conduct business with foreign counterparties.
- Russian banks that are still able to access SWIFT may face higher transaction costs, as they may need to use alternative, less efficient messaging systems.
- The SWIFT ban may make it more difficult for foreign investors to invest in Russia, as it may be more challenging to transfer money into and out of the country.

Alternatives to SWIFT

Russia has developed its own alternative messaging system, the System for Transfer of Financial Messages (SPFS). However, SPFS is not as widely used as SWIFT, and it is not clear whether it will be able to fully replace SWIFT for Russian banks.

The Need for Alternative Financial Messaging Systems in the Wake of the SWIFT Ban

The SWIFT ban on Russia has reignited discussions about the need for alternative financial messaging systems. While SWIFT remains a dominant force, several factors highlight the potential benefits and motivations for developing alternatives:

- **Increased Geopolitical Risks:** The SWIFT ban demonstrates how geopolitical tensions can be weaponized to disrupt financial flows. Countries may seek alternatives to mitigate vulnerability to future sanctions or exert geopolitical influence through their own systems.
- **Reduced Reliance on a Single System:** Overdependence on a single system like SWIFT poses a systemic risk. Alternative systems can diversify the landscape, potentially enhancing resilience and redundancy in global financial communication.
- **Emerging Technological Landscape:** New technologies like blockchain and distributed ledger technology offer secure and decentralized solutions for financial messaging, potentially challenging the traditional centralized model of SWIFT.
- **Specific Regional Needs:** Existing systems may not adequately address the needs of emerging economies or specific regions. Regional messaging systems can cater to local nuances and facilitate cross-border transactions within their spheres.
- **Innovation and Competition:** Alternative systems can foster innovation in the financial messaging space, driving competition and potentially leading to more efficient and user-friendly solutions.
- **Addressing SWIFT Limitations:** SWIFT has its own limitations, like high costs and complex compliance requirements. Alternative systems can aim to address these shortcomings, offering more accessible and flexible options for smaller financial institutions or specific transaction types.

However, developing and implementing successful alternative systems presents challenges:

- **Network Effect:** SWIFT benefits from a vast network of participants, creating a strong network effect. New systems struggle to achieve critical mass and attract sufficient users initially.
- **Technical and Regulatory Hurdles:** Building and maintaining a secure and reliable messaging system requires significant technical expertise and infrastructure. Navigating complex regulatory environments can further complicate the process.
- **Interoperability and Integration:** Connecting seamlessly with existing systems and ensuring smooth interactions between various messaging platforms is crucial for efficient global financial communication.
- **Economic and Legal Issues:** The viability of alternative systems depends on factors like adoption rates, transaction volumes, and associated costs. Legal frameworks may need to adapt to accommodate new systems and their operations.

- Overall, the need for alternative financial messaging systems is increasingly recognized. While challenges remain, their development and proliferation could contribute to a more diversified, resilient, and inclusive global financial ecosystem.

IGNITE YOUR MIND

Do you think the issues highlighted by the LoU misuse, SWIFT vulnerability, and Nirav Modi scam expose fundamental weaknesses in the Indian banking system's internal controls, risk management, and regulatory oversight? How can these vulnerabilities be addressed effectively?

Gujarat International Financial Tech (GIFT) City

GIFT City in Gandhinagar, Gujarat is an International Financial Services Centre (IFSC). IFSCs such as GIFT City are set up under the Special Economic Zones (SEZ) Act, 2005. It is a place which has a high concentration of financial institutions such as Banks, Stock market brokers, Insurance firms, Fintech firms, etc

Such places get relief and exemptions from the Corporation Tax on their profits under the Income Tax Act, 1961. These also receive various relaxations in the norms by various regulators for instance RBI, SEBI, etc

These special zones are regulated under the IFSC Authority Act of 2019 which sets up a unified IFSC Authority. The Authority acts as a single window platform for regulating various financial activities in the IFSC jurisdiction. The Headquarter of the IFSC Authority is set up at Gandhinagar, Gujarat

Recent Developments at the GIFT City, Gandhinagar

- Deakin University (Australia) will become the first foreign university to set up a campus in GIFT City, Gujarat. It'll not be regulated by UGC, but by IFSC Authority.
- Proposed Variable Capital Companies (VCCs) at the GIFT City:
  - VCC is a special type of company that deals with several collective investment schemes such as in shares, bonds, real estate, etc thereby acting as Foreign Portfolio Investment (FPI) in other countries. Unlike the traditional Mutual Funds/ Hedge Funds, it has greater operational flexibility due to laxed regulatory norms.
  - The Krishnan Committee set up in 2021 has recommended the government to allow setting up of VCCs in India.
- India International Bullion Exchange (IIBX) is India's first Bullion exchange to be set up in GIFT City in 2022.
- Recently, Budget 2023-24 has announced to encourage the setting up of Data embassies in GIFT City to provide backup, protect sensitive data from natural/ man-made disasters, cyber attacks, etc
- A Data embassy is a place where a country stores its significantly important data in a secure location in another country

Strategic Disinvestment

It is a type of Disinvestment/ Privatisation of the government-owned companies/ PSUs in order to shut down sick industries as well as generate revenue to fulfil the growing capital requirements required for capital expenditure.

Timeline of Disinvestment:

Year	Disinvestment initiatives
1991	The term 'Disinvestment' was used for the time in the New Industrial Policy announced under the Interim Budget of 1991
1998	Phased Disinvestment under the Vajpayee era in the non-strategic sectors
2009-14	Under the UPA II, all government companies could be divested up to 49%. Government was however required to keep a minimum of 51% voting share. The money obtained from Disinvestment went to the National Investment Fund (NIF) under the Public Account. This money was used for the recapitalisation of Banks, etc
2014 onwards	Government launched the Strategic Disinvestment Policy of 2015-20, and the New Public Sector Enterprises (PSE) Policy, 2021. It further aimed to generate more revenue from the idle assets of the government by the sale/lease of such assets under the National Monetisation Pipeline (NMP), 2021

Under the New Public Sector Enterprises (PSE) Policy, 2021, the government has divided the sectors for strategic disinvestment under two heads: Strategic and Non-Strategic Sectors.

The Strategic Sectors are based broadly on the criteria of national security, energy security, critical infrastructure, provision of financial services and availability of important minerals

Strategic Sectors	Non Strategic Sectors
These sectors include Nuclear energy, space, defence, power, coal, telecom, banking and insurance, etc	It includes all other sectors
In these sectors, minimum one government company will be kept, whereas the rest will be merged, privatised, or shut down	In these sectors, no government company will be kept and the existing ones will either be privatised or shut down eg. HMT watches

National Monetisation Pipeline (NMP), 2021 is an initiative to sell/ rent/ lease land/ building/ assets of CPSEs/ Railways/ Highways in order to mobilise Rs. 6 lakh crores by 2025

Advance Pricing Agreement (APA)

Advance Pricing Agreements (APAs) are agreements between the tax authority and a person (taxpayer) which determines, in advance, the **Arm's Length Price (ALP)** or specifies the manner of the determination of ALP (or both) in relation to an international transaction. In other words, Advance Pricing Agreements (APAs) are formal arrangements between a taxpayer and a tax authority, that **establish a predefined transfer pricing methodology for transactions involving related entities**.

Arm's Length Principle is a transfer pricing principle which is used to determine transfer pricing for transactions between related entities . This principle asserts that the price agreed in a transaction between two related parties must be identical to the price agreed upon in a comparable transaction involving two unrelated parties.

Transfer pricing refers to the pricing of goods, services, or intellectual property transferred between different entities within the same multinational enterprise group. These entities could be subsidiaries, affiliates, or divisions of the same company but operating in different countries or jurisdictions.

APAs prevent transfer pricing disputes in advance, i.e., before the cross-border related party transaction actually takes place or, at least, before a dispute arises in respect of such cross- border transaction. The transfer pricing is decided in advance by the tax authorities and the taxpayers, so as to prevent any dispute arising from such transfer pricing.

Types of APAs

- **Unilateral APA:** where an agreement is reached between the taxpayer and the tax authority of the taxpayer's home country.
- **Bilateral or Multilateral APA:** In bilateral or multilateral APAs, agreements involve both the taxpayer's home country's tax authority and the tax authority of one or more foreign countries where related entities are located.

The Advance Pricing Agreement (APA) programme was introduced in India through **Finance Act, 2012** and are administered by **Central Board of Direct Taxes (CBDT)**. Under the Indian APA programme, APAs can be bilateral (involving CBDT and the tax authorities of another country) or unilateral (involving the CBDT only).

CONCLUSION

The banking sector in India continues to evolve amidst challenges and reforms. While it grapples with issues of non-performing assets, frauds, and regulatory lapses, it also showcases resilience through systemic reforms, technological advancements, and revised governance frameworks. Stricter regulations, digital innovations, and revised lending practices are reshaping the sector's landscape, aiming to enhance transparency, customer service, and risk management. Despite the hurdles, the sector remains a critical pillar of the economy, adapting to changing demands and striving for greater financial inclusion, stability, and efficiency.

Fiscal Policy

9

INTRODUCTION

Fiscal policy is the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions. It is based on the ideas of John Maynard Keynes, who argued that governments could stabilize the business cycle and regulate economic output by adjusting spending and tax policies.

Components of Fiscal Policy

- **Taxation policy:** This involves setting the rates and types of taxes that the government collects from individuals and businesses. Taxation policy affects the disposable income of the people, the profitability of the firms, and the aggregate demand and supply in the economy.
- **Expenditure policy:** This involves deciding how much and in what areas the government spends its revenue. Expenditure policy affects the provision of public goods and services, the creation of infrastructure, and the redistribution of income and wealth.
- **Investment and disinvestment policy:** This involves managing the government's assets and liabilities, such as public sector enterprises, financial institutions, and sovereign wealth funds. Investment and disinvestment policy affects the efficiency and competitiveness of the public sector, the fiscal deficit and debt, and the availability of resources for development.
- **Debt or surplus management:** This involves borrowing or saving money to finance the gap between the government's revenue and expenditure. Debt or surplus management affects the interest rates, money supply, and credit availability in the economy.

THE OBJECTIVES OF FISCAL POLICY
Full Employment
Achieving and maintaining maximum employment levels in the economy.
Price Stability
Controlling inflation and avoiding deflation to maintain stable prices.
Economic Growth
Promoting long-term economic growth and development
Income Distribution
Addressing issues of income inequality and promoting a more equitable distribution of wealth.
Stabilization of Business Cycles
Smoothing out the peaks and troughs of the economic cycle

Fig. 9.1: Objectives of Fiscal Policy

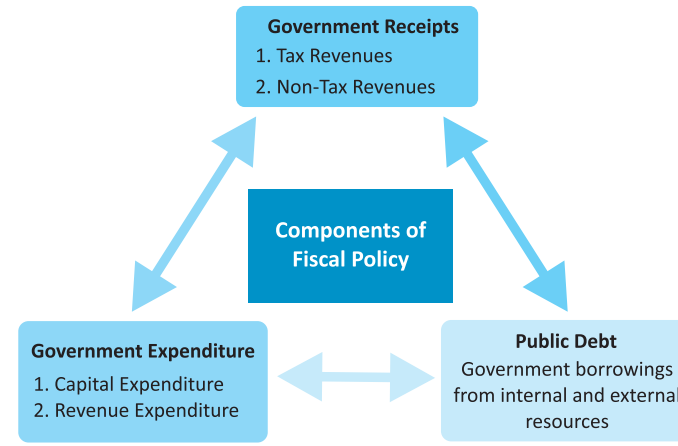


Fig. 9.2: Components of Fiscal Policy

Types of Fiscal Policy

Expansionary Fiscal Policy and **Contractionary Fiscal Policy** are the two distinct approaches to managing the economy through government spending and taxation. Each policy is implemented based on the prevailing economic conditions and the desired outcomes.

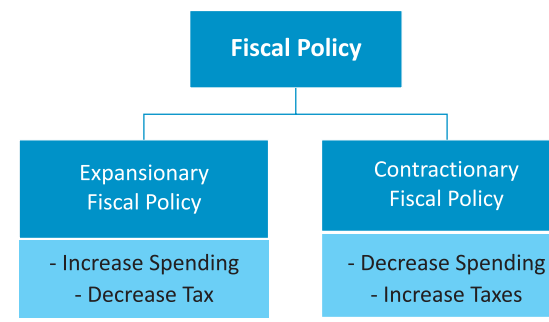


Fig. 9.3

Here's an Explanation of Both Types

- **Expansionary Fiscal Policy:**
  - **Purpose:** Stimulating Economic Growth: The primary goal of expansionary fiscal policy is to boost economic activity during periods of recession or economic downturns.
  - **Tools:**
    - **Increase in Government Spending:** The government allocates more funds to public projects, infrastructure, and social programs.
    - **Tax Cuts:** Reductions in taxes, especially for businesses and individuals, to increase disposable income and stimulate consumer spending.

- **Impact:**
  - **Boost Aggregate Demand:** By increasing government spending and reducing taxes, there is a direct injection of money into the economy, leading to higher consumer spending and business investment.
  - **Job Creation:** Increased economic activity typically results in more job opportunities, helping to reduce unemployment.
  - **Preventing or Ending Recessions:** Expansionary fiscal policy is often used to counter the negative effects of economic contractions.
- **Examples:** During the 2008 financial crisis, many governments implemented expansionary fiscal policies, including stimulus packages and tax cuts, to prevent a deep and prolonged recession.

❑ **Contractionary Fiscal Policy:**

- **Purpose:** Contractionary fiscal policy is employed when the economy is growing too quickly, leading to inflationary pressures.
- **Tools:** The government reduces its expenditure on public projects and programs.
  - **Tax Increases:** Raising taxes, especially on consumption or high-income individuals, to reduce disposable income and slow down spending.
- **Impact:**
  - **Reduce Aggregate Demand:** By cutting government spending and increasing taxes, there is a decrease in the overall demand for goods and services.
  - **Control Inflation:** Slowing down economic activity helps prevent the economy from overheating and experiencing unsustainable levels of inflation.
- **Stabilize the Economy:** Contractionary fiscal policy aims to maintain a balanced and stable economic environment.
- **Examples:** If an economy experiences high inflation, a government might implement contractionary fiscal measures to cool down the economy. This was seen, for instance, in the late 1970s and early 1980s when several countries, including the United States, used contractionary policies to combat high inflation.

Other than the 2 broader categorizations of Fiscal Policy, we have other forms of Fiscal policy as well such as situational and need-based. These are tabulated below in short:

S. No.	Type of Fiscal Policy	Purpose	Tools	Impact
1.	Automatic Stabilizers	Automatically stabilize the economy without explicit government action	Progressive Income Taxes. Unemployment Benefits	Provides automatic support during economic downturns, contributing to economic stability
2.	Discretionary Fiscal Policy	Deliberate decisions to change government spending or taxation	New Laws or Budget Changes	Allow for conscious policy adjustments in response to economic conditions
3.	Non-Discretionary Fiscal Policy	Automatic changes in government spending or taxation	Changes in tax revenues and government spending based on the economic cycle	Involves automatic adjustments without the need for explicit government decisions
4.	Progressive Taxation	Addresses income inequality by taxing higher incomes more heavily	Higher Average Tax Rate for Higher Incomes	Helps reduce income inequality by placing a higher burden on those with higher incomes
5.	Regressive Taxation	May contribute to income inequality by taxing lower incomes more heavily	Higher Average Tax Rate for Lower Incomes	Can exacerbate income inequality as lower-income individuals bear a higher relative tax burden
6.	Proportional Taxation	Provides a uniform tax burden across different income levels	Constant Average Tax Rate	Ensures that the tax burden is proportionate to income, maintaining a consistent rate for all individuals
7.	Structural Fiscal Policy	Long-term policies addressing underlying economic issues	Tax Reforms. Changes in Public Spending	Aims to promote economic growth and stability over the long term
8.	Temporary Fiscal Policy	Short-term measures in response to immediate economic challenges	Stimulus Packages. Emergency Spending	Offers quick relief and support during economic crises, preventing prolonged downturns

Pro-Cyclical and Counter-Cyclical Fiscal Policy

Pro Cyclical Policy	Counter-Cyclical Fiscal Policy
Definition: A pro-cyclical fiscal policy is one in which the **government's fiscal actions reinforce and exacerbate the existing economic conditions.** In other words, during economic expansions, pro-cyclical policies tend to be expansionary, and during economic contractions, they tend to be contractionary. **Characteristics:** **Expansionary during Booms:** Pro-cyclical fiscal policies involve increasing government spending and reducing taxes during economic booms, which can contribute to overheating and inflationary pressures. **Contractionary during Recessions:** Conversely, during economic downturns, pro-cyclical policies involve cutting government spending and raising taxes, which can deepen and prolong recessions. **Example:** ❑ If a government increases spending on public projects and cuts taxes when the economy is already booming, it may contribute to inflationary pressures and asset bubbles.	**Definition:** A counter-cyclical fiscal policy is one in which the **government's fiscal actions work against the natural fluctuations of the business cycle.** It involves using fiscal measures to stabilize the economy, mitigating the impact of economic booms and busts, for instance, an expansionary policy during a slowdown. **Characteristics:** **Expansionary during Recessions:** Counter-cyclical fiscal policies involve increasing government spending and reducing taxes during economic downturns to stimulate demand and job creation. **Contractionary during Booms:** Conversely, during economic expansions, counter-cyclical policies involve cutting government spending and raising taxes to prevent overheating and control inflation. **Example:** ❑ If a government implements a stimulus package during a recession by increasing spending on infrastructure projects and cutting taxes to boost consumer spending, it's employing a counter-cyclical fiscal policy.

Considerations While Adopting a Fiscal Policy Framework

- **Current Economic Conditions:**
  - **Stage of the Business Cycle:** Understanding whether the economy is in a recession, expansion, or at a peak helps determine whether expansionary or contractionary fiscal policies are more suitable.
  - **Inflationary Pressures:** Assessing the level of inflation guides the choice between policies. Expansionary policies may be needed in a recession, while contractionary policies can address inflationary pressures.
- **Policy Objectives:**
  - **Full Employment:** If unemployment is a concern, expansionary fiscal policies may be employed to stimulate job creation.
  - **Price Stability:** Contractionary fiscal policies may be implemented to control inflation and maintain stable prices.
  - **Economic Growth:** Consideration of long-term growth objectives may influence the allocation of resources toward investment in infrastructure, education, and technology.
- **Fiscal Space and Budgetary Constraints:** The fiscal space, or the capacity of the government to implement fiscal policies, is crucial. It depends on the existing level of government debt, fiscal deficits, and the ability to raise revenue.
- **Public Debt Sustainability:** Assessing the current level of public debt is essential to ensure that fiscal policies do not lead to unsustainable debt levels, which could have long-term negative consequences.
- **Time Lags and Implementation Time:** Recognizing that fiscal policies, especially discretionary ones, often have time lags between implementation and impact. Policymakers should consider the timing of policy changes relative to the economic cycle.
- **Political and Public Support:**
  - **Political Will:** The political climate and government commitment to a particular fiscal policy framework are crucial for successful implementation.
  - **Public Acceptance:** Considering public opinion and support is important, as fiscal policies may affect citizens directly through changes in taxation and government spending.
- **Global Economic Context:** Considering the impact of global economic conditions, trade relationships, and currency exchange rates is important, as they can influence the effectiveness of fiscal policies.
- **Coordination with Monetary Policy:** Ensuring coordination between fiscal and monetary policies to avoid conflicting objectives and enhance overall economic stability.
- **Structural Reforms:** Complementing short-term fiscal policies with structural reforms can address underlying issues in the economy, promoting sustainable growth and stability.

IGNITE YOUR MIND

Considering the considerations mentioned for adopting a fiscal policy framework, do you think achieving a balance between short-term economic goals and long-term sustainability is feasible?

- **Social and Environmental Considerations:**
  - **Equity and Social Welfare:** Evaluating the distributional impact of fiscal policies to ensure they promote fairness and address social inequalities.
  - **Environmental Sustainability:** Considering the environmental impact of policies and incorporating measures that promote sustainability.
- **Economic Flexibility and Adaptability:** Adopting fiscal policies that can be adjusted in response to changing economic conditions allows flexibility and adaptability.

Budget Procedure

Meaning and Definition

A budget can be defined as the most basic and comprehensive financial report in which **revenues from all the sources and outlays for all activities are consolidated.** In simple terms, the budget is an **annual financial statement of the revenue and expenditure** of a government.

Budget procedure refers to the formal process through which a government **plans, develops, approves, executes, and monitors** its budget. This process typically involves **several stages, each serving a specific purpose** in managing public finances. Some common steps include:

Overarching Framework of Budget Procedure

Step 1	Budget Formulation	Planning	Government develops the budget proposals based on national goals.
		Proposal Submission	Ministries submit their budget proposals to the finance ministry
Step 2	Budget Approval	Review	Finance ministry reviews the proposals and makes adjustments.
		Legislative Approval	The budget is presented to the legislative body for debates and voting.
Step 3	Budget Execution	Implementation	Once approved, the budget is executed by government agencies.
		Monitoring	It ensures that spending aligns with budget and to avoid deviations.
Step 4	Auditing and Accountability	Auditing	Independent auditors review financial transactions to ensure compliance with budgetary regulations.
		Accountability	Government officials are held accountable for the use of public funds.
Step 5	Budget Evaluation and Adjustments	Evaluation	Assessments are conducted to determine the effectiveness and impact of budgetary spending.
		Adjustments	Based on the evaluation, adjustments may be made to future budgets.

Constitutional Provisions For Budget

It is a statement of the **estimated receipts and expenditure of the Government** in a financial year (which begins on 1st April of the current year and ends on 31st March of the following year).

S. No.	Article Number	Provision
1.	Article 112	The President shall, in respect of every financial year, cause to be laid before Parliament, Annual Financial Statement.
2.	Article 265	No tax shall be levied or collected except by authority of law. Taxation needs the approval of Parliament.
3.	Article 266	No moneys out of the Consolidated Fund of India or the Consolidated Fund of a State shall be appropriated except in accordance with law and for the purposes and in the manner provided in this Constitution.

Under **Article 77 (3)**, the President of India has delegated to the **Union Finance Minister** the **responsibility of preparing the budget** and shepherding it through parliament.

Since 2017, the Indian Budget has been presented on **1 February**. As a convention, the **Economic Survey** is also tabled in the Parliament – **one day before budget submission**, i.e. on **January 31**. In an **election year**, the Budget may be presented twice — **first to secure a Vote on Account for a few months and later in full.**

Other than **"estimated receipts and expenditure of the Government"** the Budget also contains the following pieces of information:

- Estimates of revenue and capital receipts,
- Ways and means to raise the revenue,
- Estimates of expenditure,
- Details of the actual receipts and expenditure of the closing financial year and the reasons for any deficit or surplus in that year, and
- The economic and financial policy of the coming year, i.e., taxation proposals, prospects of revenue, spending program and introduction of new schemes/ projects

Budget Making Procedure in India

In India, the **Budget Division of the Department of Economic affairs** under the purview of the **Ministry of Finance** is the **nodal body** responsible for preparing the Budget. It is presented by the **Finance Minister in the parliament** for approval.

Six Stages of Budget Approval Process in India

- **Budget Presentationsss**
  - The Finance Minister presents the budget, including key documents like the economic survey, budget classification, ministry reports, an explanatory memorandum, the Appropriation Bill, and the Finance Bill.
  - This is done on February 1, marking the start of the budget process.
- **General Discussion**
  - Lasting 3-4 days, the Lok Sabha discusses the budget in general terms, focusing on overall policy and principles, without voting on any motions.
  - The Finance Minister concludes this stage with a response to the discussions.
- **Scrutiny by Departmental Committees**
  - After general discussions, the Parliament adjourns for 3-4 weeks.
  - During this period, departmental standing committees review the budget demands of various ministries and prepare reports.
- **Voting on Demands for Grants**
  - The Lok Sabha votes on the Demands for Grants, a process exclusive to this house.
  - Members can propose cut motions to reduce the amount of grants.
- **Passing of Appropriation Bill**
  - After debate, the Appropriation Bill is voted on in Parliament.
  - It authorizes expenditure from the Consolidated Fund and becomes an Act with the President's approval.
- **Passing of Finance Bill**
  - This bill legalizes the income side of the budget.
  - It must be passed within 75 days, and members can propose amendments related to taxation.

Documents Submitted in The Parliament of India by The Finance Minister Along with The Budget Documents are

S. No.	The Budget documents presented to Parliament comprise, besides the Finance Minister's Budget Speech, the following:
1.	Annual Financial Statement (AFS) – Article 112
2.	Demands for Grants (DG) – Article 113
3.	Appropriation Bill – Article 114 (3)
4.	Finance Bill – Article 117
5.	Memorandum Explaining the Provisions in the Finance Bill
FRBM Act mandates following additional documents to be laid along with Budget	
6.	Macro-economic framework for the relevant financial year
7.	Fiscal Policy Strategy Statement for the financial year
8.	Medium Term Fiscal Policy Statement
9.	Medium Term Expenditure Framework Statement
Other relevant documents	
10.	Expenditure Budget Volume-1 and Volume-2
11.	Status of Implementation of Announcements made in Finance Minister's Budget Speech of the previous financial year

Budget Classification

Article 112 of the Indian Constitution makes a requirement in India to **present before the Parliament** a statement of **estimated receipts and expenditures** of the government in respect of **every financial year** which runs from **1 April to 31 March.**

Revenue Versus Capital Budget

Revenue and Capital budgets are two distinct components of a government's overall budget framework, each serving different purposes and managing different types of expenditure.

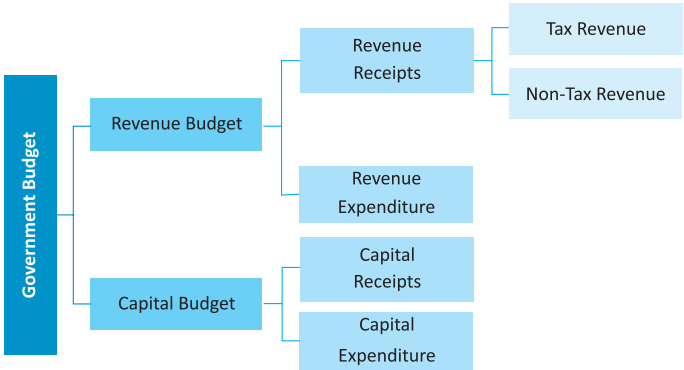


Fig. 9.4: Government Budget Division

Here's a Breakdown of Their Key Differences

Revenue Budget:

- **Focus:** Deals with the government's **day-to-day expenses** and receipts.
- **Income:** Comprises all the **revenue earned** by the government through taxes, fees, fines, and other income-generating activities.
- **Expenditure:** Covers expenses essential for running the government, like salaries, administrative costs, subsidies, interest payments on debt, and social welfare programs like pensions and unemployment benefits.
- **Objective:** Maintain **fiscal stability** by ensuring sufficient revenue to meet day-to-day expenses and avoid excessive deficits.

Capital Budget:

- **Focus:** Deals with the government's **long-term investments** and asset creation.
- **Income:** Can be funded through borrowing, surplus from the revenue budget, or specific levies like infrastructure cess.
- **Expenditure:** Covers investments in **infrastructure development**, capital expenditure on projects like roads, bridges, railways, power plants, irrigation systems, and public buildings.
- **Objective:** Promote **economic growth** by creating productive assets, improving infrastructure, and stimulating long-term economic development.

Feature	Revenue Budget	Capital Budget
Focus	Day-to-day expenses and receipts	Long-term investments and asset creation
Income	Taxes, fees, fines, etc.	Borrowing, surplus, specific levies
Expenditure	Salaries, administration, subsidies, social programs	Infrastructure, capital projects
Objective	Fiscal stability	Economic growth
Impact	Short-term economic activity	Long-term economic development

General Budget Versus Railway Budget

The general budget and railway budget constitute two components of the Government of India's annual financial statement.

- Initially separated in 1924 on the recommendation of the **Acworth Committee** for greater autonomy, the railway budget exclusively addressed the financial estimates of Indian Railways and was presented a day before the general budget.
- However, **in 2017, the railway budget was integrated into the general budget**, aiming to eliminate inefficiencies and distortions identified by the NITI Aayog and the Bibek Debroy Committee.
  - This merger sought to end the politicization of the railway budget, rationalize tariff structures, enhance the financial health of the railways, and boost capital expenditure.

Plan Vs Non-Plan Expenditure Budget

Until 2017, India used the plan and non-plan expenditure budgets to classify government spending.

- Plan expenditure was for productive and developmental projects of ministries. Sectors like agriculture, irrigation, education, healthcare, rural development, and energy received priority under plan expenditure
- Non-plan expenditure was for non-productive and mandatory items like salaries, subsidies, and interest payments.
- In 2017, this classification was changed based on the **C Rangarajan Committee** and the **NITI Aayog's recommendation**.
- The new classification is based on capital and revenue expenditure.
  - Capital expenditure is for creating assets or reducing liabilities, such as loans, infrastructure, and investments.
  - Revenue expenditure is for maintaining the existing operations, such as pensions, wages, and subsidies.

INTERIM BUDGET

Need and Time: When a government is unable to present a complete budget in Parliament, either due to time constraints or because general elections are imminent, an interim budget is introduced. It's deemed more appropriate for the newly elected government to formulate a comprehensive budget in cases where elections are approaching.

How Interim Budget Serves Financial Needs

A comprehensive budget grants the current government the authority to incur expenditures up until the end of the fiscal year, which concludes on March 31st. If the government fails

to present a full budget before the fiscal year's end, it must obtain parliamentary approval to spend in the new fiscal year until a new budget is approved.

While the Parliament reviews and approves the budget for the entire year, the government utilizes an interim budget. During this period, a Vote-On-Account is passed, enabling the government to cover its administrative expenses until the full budget is sanctioned.

Difference Between Interim Budget and Regular Budget in India

Feature	Interim Budget	Regular Budget
Purpose	Primarily intended to ensure that the government has sufficient funds to operate until a new government forms	Provides a complete financial statement for the upcoming fiscal year, detailing government spending and revenues.
Duration	Covers a short period, usually a few months to a year	Covers the entire fiscal year, from April 1 to March 31.
Content	Typically includes only essential expenditures and does not introduce major fiscal policy changes or new schemes.	Contains detailed financial plans, including expenditures, revenues, and potentially new policies or schemes.
Policy Announcements and Tax Proposals	Avoids major policy announcements or changes	Includes major policy announcements and new initiatives.
Scope of Approval	Seeks approval for necessary government expenses to keep the administration running until the full budget is passed.	Seeks parliamentary approval for all government expenses and revenues for the entire fiscal year.
Legislative Scrutiny	Undergoes less intense scrutiny compared to a full budget, as it is temporary and limited in scope.	Undergoes extensive scrutiny and discussion in the legislature, including debates and committee reviews.

IGNITE YOUR MIND

Considering the shift in budget presentation timing, do you think presenting the budget on February 1 allows for better planning and execution of government policies? What adjustments, if any, would you propose to improve the budget presentation process?

THE OUTPUT- OUTCOME MONITORING FRAMEWORK (OOMF) IN INDIA

It focuses on the results and impacts of government spending, involving various ministries, departments, and institutions.

Purpose of OOMF

The framework aims to shift from traditional input-based budgeting to outcome-oriented budgeting in India, ensuring that government expenditures lead to significant, measurable outcomes that positively affect society.

Output vs. Outcome Definitions

Output	Outcome
Immediate results or products of government activities, like infrastructure built or services rendered.	Long-term societal impact of these outputs, like improved healthcare or better transportation.

Implementation and Monitoring Across Ministries and Departments

Each government department and ministry in India, from Health to Transportation, is required to create an output-outcome matrix for every scheme in their budget proposals. This matrix clarifies the expected outcomes related to the outputs from their spending.

Central institutions, like the Ministry of Finance and the NITI Aayog (National Institution for Transforming India), play crucial roles in monitoring and evaluating the outcomes. They ensure that the programs meet their intended goals and provide insights for policy adjustments.

Accountability and Transparency Enhancement

The framework increases accountability and transparency in public spending. It makes it clearer for Indian citizens how their taxes are being utilized and the benefits they are creating.

Influence on Policy Making

By providing outcome-based data, the framework supports **evidence-based policymaking,** influencing future policy decisions and budget allocations in India.

In summary, the OOMF in India involves a collaborative effort across various ministries, departments, and central institutions, all working towards ensuring that government spending is not only efficient but also effective in achieving tangible, beneficial outcomes for the country.

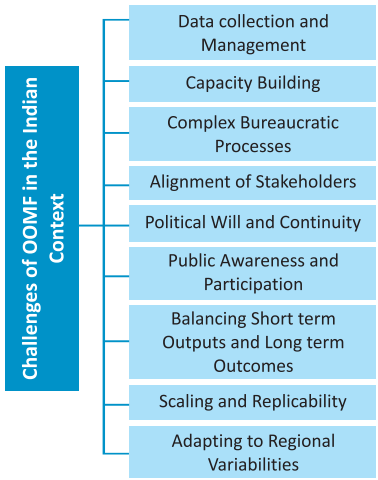

Challenges of OOMF in the Indian Context
Data collection and Management
Capacity Building
Complex Bureaucratic Processes
Alignment of Stakeholders
Political Will and Continuity
Public Awareness and Participation
Balancing Short term Outputs and Long term Outcomes
Scaling and Replicability
Adapting to Regional Variabilities

Fig. 9.5

GENDER BUDGETING (GB)

Gender Budgeting (GB) is a strategic approach that **focuses on ensuring a gender-sensitive formulation and implementation of legislation, programs, and schemes**. It involves analyzing and monitoring government budgets to assess their impact on different genders, aiming to address disparities and ensure equitable benefits from development for both women and men.

Rather than creating a separate budget, Gender Budgeting seeks affirmative action to cater specifically to women's needs and assesses public expenditure and service delivery from a gender perspective.

The Five-Step Framework for Gender Budgeting Includes

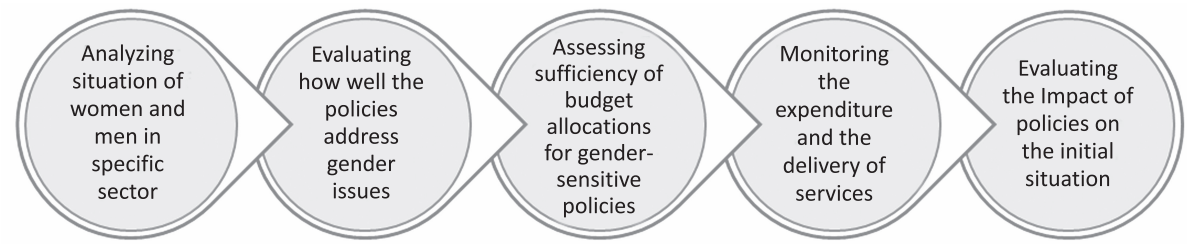

Analyzing situation of women and men in specific sector
Evaluating how well the policies address gender issues
Assessing sufficiency of budget allocations for gender-sensitive policies
Monitoring the expenditure and the delivery of services
Evaluating the Impact of policies on the initial situation

Fig. 9.6: Government Budget Division

Need For Gender Budgeting in India

In India, the Gender Budget Statement (GBS) was introduced in the 2005-06 budget. The rationale for Gender Budgeting stems from recognizing the disparities women face in accessing resources and services, despite constituting nearly half of India's population. It acknowledges that many sectors considered 'gender neutral' often fail to recognize their implications on women.

Features of Gender Budgeting in India

- **Global Recognition:** India's gender budgeting is notable for its influence on both expenditure and revenue policies, including aspects like varied tax rates for men and women, and is extended to state-level governance.
- **Beyond Accounting:** Gender budgeting in India transcends traditional accounting practices, aiding ministries traditionally viewed as gender-neutral in developing new programs specifically for women.
- **Establishment of Gender Budgeting Cells (GBCs):** These cells are mandatory in all ministries/departments and play a key role in gender-based analysis, assessing the needs and impacts of various schemes on women, and identifying areas where public expenditure can be better oriented to address women's needs.
- **Function of GBCs:** These cells undertake tasks such as gender impact analysis, assessing the needs of beneficiaries, and analyzing the incidence of benefits among women to guide the reallocation of public expenditure and enhance the effectiveness of program implementation.

Challenges of Gender Budgeting in India

1. **Reduced Proportion in Union Budget:**
   - **Issue:** The gender budget's share in the total Union Budget expenditure has been diminishing.
   - **Example:** Comparing the annual budget allocations over the years may reveal a declining trend in the percentage allocated specifically for gender budgeting initiatives.
2. **Limited Major Women-Centric Schemes:**
   - **Issue:** A scarcity of large-scale, high-impact schemes focused exclusively on women.
   - **Example:** Apart from a few key programs like the Nirbhaya Fund (for women's safety) and the Beti Bachao Beti Padhao campaign (to address the declining child sex ratio), there are limited large-scale schemes under the Ministry of Women and Child Development.
3. **Shortage of Dedicated Human Resources:**
   - **Issue:** Insufficient specialized staff to execute Gender Budgeting Cell (GBC) strategies.
   - **Example:** Challenges in implementing complex schemes such as the Swadhar Greh (shelter for women in difficult circumstances) may be attributed to a lack of adequately trained personnel.

4. **Weak Monitoring Mechanisms:**
   - **Issue:** Lack of a robust, national-level system for monitoring gender budget initiatives.
   - **Example:** The effectiveness of gender-specific allocations in schemes like the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) might not be adequately monitored for their impact on women.
5. **Questions on Allocation Reporting**
   - **Issue:** Doubts regarding the accuracy and efficacy of reporting under Gender Budget Statement.
   - **Example:** It's often unclear how schemes listed under Part B, which are supposed to benefit women significantly (like certain health or education schemes), are in fact actually ensuring that at least 30% of their funds are directed towards women, raising questions about their real impact on gender equality.

General Criticism of Union Budget in India

1. **Unrealistic Budget Projections:** Often, the initial budget estimates do not align with realistic expectations. This leads to frequent adjustments and additional budgetary requests. Conversely, there are instances of significant unutilized funds at the end of the fiscal year.
2. **Delayed Project Execution:** The spreading of resources across numerous projects, sometimes with minimal funding, often results in significant delays in project completion.
3. **Uneven Expenditure Distribution:** A large portion of the budget tends to be expended in the final quarter of the financial year, particularly in the last month, for instance, **March Rush**, leading to an imbalanced spending pattern.
4. **Lack of Long-Term Planning Alignment:** Despite having a Five-Year Plan for a multi-year perspective, ad hoc deviations often undermine long-term planning objectives. Budgetary allocations for planned schemes are frequently fragmented and lack consolidation in estimates and final accounts, necessitating better synchronization between planning, budgeting, and accounting.
5. **Discrepancy Between Expenditure and Delivery:** The reported expenditure figures don't necessarily reflect the actual amount spent on receiving goods and services.
6. **Inaccurate Representation of Financial Position:** The tendency of implementing agencies to park funds outside of government accounts results in a misrepresented financial position. This issue also implies that the government's financial status is not accurately known at any specific time.
7. **Ad Hoc Announcements of Projects:** There is a trend of making impromptu announcements about projects or schemes that are not included in the planned budget. Often these are made without adequate planning or detailing.

To address these issues, reforms have been suggested by the **2nd Administrative Reforms Commission (ARC) in its 14th Report on Public Finance Management**. These reforms include enhancing overall governance **transparency,** greater **accountability, aligning annual budgets** with **medium-term plans,** adopting **top-down** budgeting techniques, ensuring **realistic budgeting,** and adopting **modern financial management practices.**

Moreover, the **15th Finance Commission** has also made several recommendations related to **fiscal management, revenue mobilization, and financial management practices.** These include suggestions to bring down **fiscal deficits, improve income and asset-based taxation, resolve issues in the GST structure,** and develop a comprehensive framework for public financial management.

These recommendations, if implemented effectively, can address the fundamental weaknesses in the budgetary process and enhance the efficiency and effectiveness of public financial management in India.

Important Measures for Budget Management in India

S. No.	Important Measures for Budget Management in India	
1.	Fiscal Responsibility Legislation	Enact and adhere to fiscal responsibility laws that set targets for deficit levels, ensuring disciplined fiscal management.
2.	Debt-to-GDP Ratio Monitoring	Regularly monitor the debt-to-GDP ratio to assess the sustainability of government debt and its impact on overall economic health.
3.	Structural Reforms	Implement structural reforms in tax policies and public expenditure management to enhance revenue generation and improve fiscal efficiency.
4.	Countercyclical Policies	Adopt countercyclical fiscal policies, running deficits during economic downturns and surpluses during periods of growth, to stabilize the economy.

S. No.	Important Measures for Budget Management in India	
5.	Investment in Productive Assets	Prioritize investments that contribute to long-term economic growth and development, ensuring that deficits lead to tangible and sustainable outcomes.
6.	Public Awareness and Communication	Foster public awareness about the rationale and implications of deficits, and maintain transparent communication to build trust and confidence in fiscal policies.

Government Accounts

Government accounts typically refer to the **financial records and transactions of government entities**. These accounts are crucial for Budgeting, Revenue and expenditure management, Accounting Standards, Auditing, balancing public debt, overall treasury Management, and ensuring Transparency and Accountability.

The constitution of India mandates the Union Government to maintain three kinds of accounts to manage the revenue and expenditure.

These are as:

Consolidated Fund of India

- This is the most important of all accounts of the government.
- This fund is filled by: Direct and Indirect taxes, Loans taken by the Indian government, and the return of loans/interests of loans to the government by anyone/ agency that has taken it
- The government meets all its expenditures from this fund.
- Each state can have its own Consolidated Fund of the state with similar provisions.
- The Comptroller and Auditor General (CAG) of India audits these funds and reports to the relevant legislatures on their management.

Contingency Fund of India

- Its corpus is ₹ 500 crores.
- It is like an imprest (money maintained for a specific purpose).
- The Secretary of the Finance Ministry holds this fund on behalf of the President of India.
- Each state can have its own contingency fund.

Recently Contingency Fund of India was in The News For Two Reasons

- Budget 2021-22 proposed to enhance the Contingency Fund of India from ₹ 500 crore to ₹ 30,000 crore through Finance Bill.
- An amount equivalent to 40 percent of the Fund corpus shall be placed at the disposal of the Secretary, Ministry of Finance, Department of Expenditure.

Public Accounts of India

- All public money (other than those covered under the Consolidated Fund of India) received by or on behalf of the Indian Government are credited to this account/fund.
- Examples: Bank savings accounts of the various ministries/departments, National small savings fund, defense fund, etc.
- Each state can have its own similar accounts.
- The audit of all the expenditure from the Public Account of India is taken up by the CAG

A Detailed Difference Table Between these Three Funds is Given Below

S. No.	Parameter	Consolidated Fund of India	Public Fund of India	Contingency Fund of India
1.	Article in Constitution of India	Article 266	Article 266(2)	Article 267
2.	Purpose	Primary account for regular government receipts and expenses	Holds funds for specific purposes, such as public savings and deposits	Emergency fund for unforeseen expenditures
3.	Source of Funds	Includes all revenues, loans, and receipts	Comprises funds held on behalf of others, like trust funds or provident funds, etc.	Consists of amounts authorized by Parliament of India for emergencies
4.	Withdrawal Mechanism	Requires parliamentary approval for withdrawals	Withdrawals governed by specific laws and purposes	President makes advances in unforeseen circumstances which later need Parliamentary ratifications
5.	Nature of Expenditure	Encompasses regular day-to-day expenses and capital investments	Allocated for specific and earmarked expenditures	Utilized for urgent and unforeseen expenses

S. No.	Parameter	Consolidated Fund of India	Public Fund of India	Contingency Fund of India
6.	Annual Financial Statement	Integral part of the government's Annual Financial Statement	Not included in the Annual Financial Statement	Not included in the Annual Financial Statement
7.	Audit	Audited by the Comptroller and Auditor General (CAG)	Subject to audit by the CAG	Subject to audit by the CAG

Note: Union Territories of India having their own Legislative Assemblies have their own Consolidated Fund, Contingency Fund, and Public Account as per **"The Government of Union Territories Act, 1963"**. The Contingency Fund of Union Territories is held by the respective **"Administrators" or "Lieutenant Governors".**

REVENUE

Taxation System

Tax is a financial charge or levy imposed by a government on individuals, businesses, or other entities to fund public expenditures and government functions. It is a compulsory contribution that citizens and businesses are required to pay, and it is a crucial source of revenue for the government.

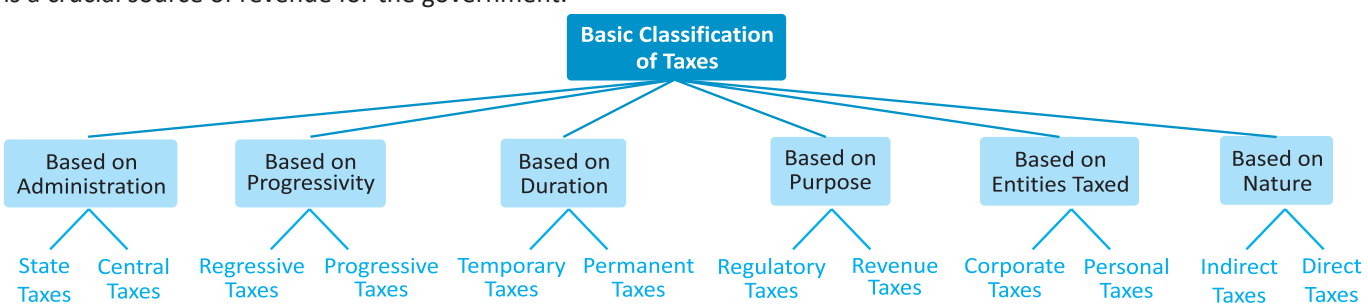


Fig. 9.7

Classification of Taxes

Taxes can be classified based on various criteria, including the nature of the tax, the entities taxed, and the purpose of taxation. Here are some common classifications:

Features of a Good Taxation System

Fairness	Adequacy	Simplicity
This is achieved through principles of vertical and horizontal equity. Vertical equity means that those with greater ability to pay, usually measured by income or wealth, should pay more. Horizontal equity refers to the principle that individuals with similar income or circumstances pay similar amounts of tax.	The tax system should generate enough revenue to fund public services and meet the government's budgetary requirements without resorting to excessive public debt.	Complexity can lead to higher compliance costs for taxpayers and administrative costs for the government, as well as increased opportunities for tax evasion and avoidance.
Transparency and Visibility	**Administrative Efficiency**	**Neutrality and Economic Growth**
Taxpayers should be able to understand how tax rates are set, how tax revenues are used, and how the tax system operates. This transparency helps in building public confidence in the tax system.	The costs of administering the tax system should be kept as low as possible without compromising its effectiveness and integrity. This Involves an efficient tax collection process and mechanisms to reduce evasion and fraud.	A good tax system should not unduly influence economic decisions. It should aim to minimize its impact on market transactions and economic behavior to avoid distorting economic activities and growth.
Flexibility and Responsiveness	**Predictability and Stability**	**Protection of Taxpayers' Rights**
The tax system should be capable of adapting to changing economic circumstances and policy needs. This allows the government to respond effectively to economic crises or shifts in public policy priorities.	Taxpayers should have certainty about the tax rules, including rates and bases, so they can plan their finances effectively. Frequent changes to tax laws can create uncertainty and instability.	A good tax system respects taxpayers' rights, including the right to privacy, the right to be informed, and the right to appeal and be heard.

Following is the classification of the various taxes levied in India based on direct and indirect nature:

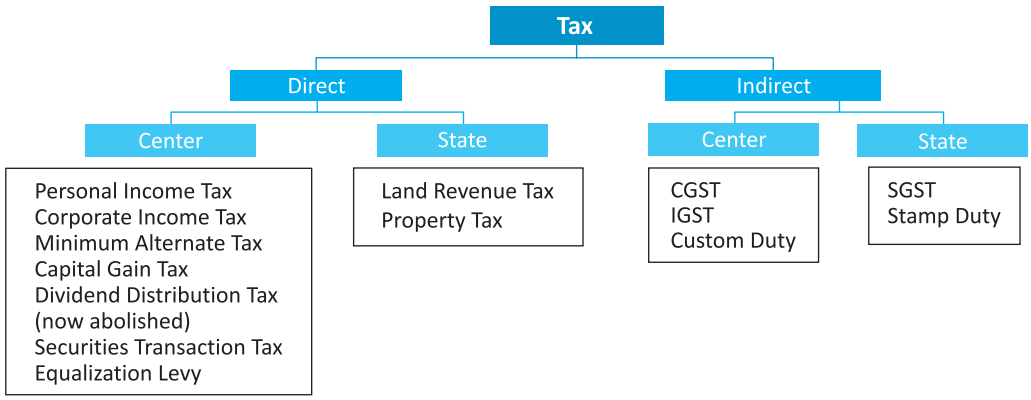


Fig. 9.8: Various taxes levied in India

Direct Taxes

A direct tax is a type of tax that is levied directly on the income, wealth, or property of individuals or organizations. Unlike indirect taxes, which are levied on goods and services and are paid indirectly by consumers (such as sales tax or VAT), direct taxes are paid directly to the government by the taxpayer.

Key Aspects of Direct Taxes Include

- **Progressivity and Fairness:** Higher-income individuals pay a larger percentage of their income in taxes compared to lower-income individuals. This is considered a fair approach, as it aligns tax liability with the ability to pay.
- **Efficiency and Transparency:** Direct taxes are generally straightforward in terms of who is paying and how much they are paying, which enhances transparency. Efficient collection mechanisms reduce administrative costs and make it easier for governments to forecast revenue.
- **Compliance and Administration:** Advanced tax systems have made compliance easier through digital filing and processing, but it remains a significant administrative task.
- **Revenue Stability:** Direct taxes, particularly income taxes, are a stable source of revenue for governments. They are less susceptible to economic fluctuations compared to indirect taxes like sales taxes, which can vary significantly with consumer spending patterns.
- **Economic and Social Policy Tool:** Governments often use direct taxes as tools for social and economic policies. For instance, tax credits or deductions can incentivize certain behaviors (like investments in education or renewable energy) and provide relief to specific groups.
- **Redistribution of Wealth:** Progressive direct taxes can redistribute wealth within a society. Higher taxes on the wealthy can fund social welfare programs, contributing to reducing income and wealth disparities.
- **Influence on Economic Behavior:** Direct taxes can influence individual and corporate behavior. High income or corporate taxes might discourage investment or encourage tax avoidance, while lower taxes might stimulate economic activity.
- **International Considerations:** In a globalized economy, the structure of direct taxes can impact international business decisions, such as where a company locates its headquarters or how individuals manage their income and assets across borders.
- **Challenges in Tax Evasion and Avoidance:** Direct taxes, especially on high incomes and large corporations, often face challenges of evasion and avoidance. Effective enforcement and international cooperation are required to address these issues.
- **Political and Social Acceptability:** Tax policies, particularly direct taxes, are often a subject of political debate and can reflect a society's values and priorities. The balance between adequate revenue generation and maintaining fairness and acceptability is a key challenge for policymakers.

The Administrative Structure For Direct Taxation in India

Central Board of Direct Taxes (CBDT), which operates under the Ministry of Finance. The CBDT is responsible for the administration of direct tax laws through the Income Tax Department. Here's an overview of the structure:

Central Board of Direct Taxes (CBDT)

- The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963.
- It provides essential inputs for policy and planning of direct taxes in India and is also responsible for the administration of direct tax laws.

Income Tax Department

- The Income Tax Department is a government agency undertaking direct tax collection.
- It is headed by the CBDT and is part of the Department of Revenue in the Ministry of Finance.

Various Direct Taxes in India

Personal income tax is calculated by consolidating all of an individual's income sources, such as their salary, rental income, and interest income. Currently, there are two tax regimes available: the new tax regime and the old tax regime. Individuals have the flexibility to opt for either the old or new tax regime for their tax payments, with the new tax regime being the default option.

S. No.	Income Range	Tax rate
1.	₹ 0 to 3 lakhs	Nil
2.	₹ 3 lakhs to 6 lakhs	5%
3.	₹ 6 lakhs to 9 lakhs	10%
4.	₹ 9 lakhs to 12 lakhs	15%
5.	₹ 12 lakhs to 15 lakhs	20%
6.	Above ₹ 15 lakhs	30%

S. No.	Income Range	Tax rate
1.	₹ 0 to 2.5 lakhs	Nil
2.	₹ 2.5 lakhs to 5 lakhs	5%
3.	₹ 5 lakhs to 10 lakhs	20%
4.	Above ₹ 10 lakhs	30%

New Tax regime: Under the new tax regime, individuals with an income of up to ₹ 7 lakh are exempt from paying any taxes. However, the new tax regime does not permit any exemptions or rebates. If one's income exceeds ₹ 7 lakhs, the following tax slabs will apply in the new tax regime.

Old tax regime: individuals are not liable to pay taxes on income up to ₹ 5 lakh. However, they have the option to claim exemptions related to savings through various schemes like PPF, NPS, etc., up to specific limits. When income exceeds ₹ 5 lakhs, the following tax slabs come into effect in the old tax regime:

Corporate income tax (CIT) is applied to the earnings of corporations, companies, and entities. All profitable companies are required to pay a fixed rate of corporate income tax.

Currently, there are two CIT structures available, and companies have the flexibility to choose between them. If a company opts not to utilize any tax exemptions, it is subject to a CIT rate of 25.17%. However, if a company chooses to claim tax exemptions, the CIT rate increases to 34.94%.

Exemptions allowed	Exemptions not allowed
CIT (standard rate) = 30%	**CIT (standard rate)** = 22%
Surcharge = 12% (on 30%) = 3.6%	**Surcharge** = 10% (on 22%) = 2.2%
CIT + Surcharge = 33.6%	**CIT + Surcharge** = 24.2%
Cess = 4% (CIT + Surcharge) = 1.344%	**Cess** = 4% (CIT + Surcharge) = 0.97%
CIT + Surcharge + Cess = 30% +3.6% +1.34% (CIT effective) = 34.94%	**CIT+ Surcharge Cess** = 22% + 2.2% + 0.97% (CIT effective) = 25.17%

Minimum Alternate Tax (MAT) is a provision introduced by the Finance Act of 1987, to address situations where a company, despite generating income, manages to reduce its tax liability or avoids paying any taxes altogether (referred to as "zero tax companies"). The primary goal of introducing MAT was to ensure that "zero tax companies," which earn significant book profits and pay substantial dividends but do not pay taxes due to various tax concessions and incentives under the Income Tax Law, are brought within the tax framework.

According to the MAT concept, a company's tax liability will be determined as the higher of the following:

(a) Tax liability computed according to the standard provisions of the Income Tax Law, which involves calculating taxes based on the company's taxable income at the applicable tax rate. This can be referred to as the regular tax liability.

(b) Tax is calculated at a fixed rate of 15% (plus cess and surcharge, totaling 17.16%) on the company's book profit, referred to as MAT.

Companies that choose the new tax rate of 25.17% for Corporate Income Tax (CIT) will be ineligible to claim tax exemptions or rebates, and as a result, the Minimum Alternate Tax (MAT) will not apply to them. For those companies that opt to claim exemptions, they will be subject to a tax rate of 34.94% or MAT.

Capital Gain Tax pertains to the taxation of profits or gains obtained from selling an asset at a price higher than its initial purchase cost. Such gains typically arise when assets like stocks, bonds, precious metals, art, or real estate are sold.

Dividend Distribution Tax (DDT) used to be a tax imposed on the dividends that a company distributed to its shareholders, representing a portion of its profits. When a company declared dividends, it was required to pay DDT on those dividends, and the shareholders were also liable to pay tax on the received dividends, based on their respective income tax rates. However, **in the 2019-20 budget, DDT was eliminated**, and instead, dividends became taxable directly in the hands of the shareholders.

Securities Transaction Tax (STT) is a tax imposed during the buying and selling of securities such as stocks, bonds, debentures, and mutual funds that are listed on Indian stock exchanges. The STT rate varies depending on the type of security being traded and whether it's a buying or selling transaction. Both the buyer and the seller are responsible for paying STT. For instance, when purchasing or selling equity shares, both the buyer and the seller are required to pay 0.1% of the share value as STT.

The Equalization Levy, also known as **"Google Tax,"** was introduced in India in **2016** to address taxation challenges posed by the **digital economy**. Before this levy, only companies with a **registered physical presence in India** were subject to **taxation under the Income Tax Act of 1961**. However, the rise of **digital services**, such as online **advertising**, presented a situation where **foreign companies** like **"Google" generated significant revenue** from **Indian sources without** having a **registered office** in **India**.

Under the Income Tax Act of 1961, if a **foreign company**, for example, **"Google,"** had a **subsidiary** ("B") **registered** in India, and "B" provided digital services such as **advertisements** or e-**commerce** platforms in India, it paid **regular** income tax. However, if "B" had **no physical presence** in India, but still conducted digital business in the country, the government **introduced** the **Equalization Levy** to address this situation. Under this levy, "B" would be liable to pay the Equalization Levy, not income tax.

The Equalization Levy is distinct from income tax and was introduced as an independent levy through the Finance Act of 2016. It covers various digital services and became effective at different dates. Initially, it was applied to the "sale of digital services (ads)," and subsequently, from April 1, 2020, it also extended to e-commerce firms.

For instance, if an e-commerce firm like Amazon, which is registered in the US and classified as a non-resident in India, earns revenue (not profit) of ₹ 100 from its online platform by selling to Indian residents, it is required to pay 2% of this revenue (₹ 2) to the Indian government as an Equalization Levy. Importantly, this levy is based on revenue, not profit. If Amazon had a permanent establishment in India with a physical presence, it would be subject to income tax on its profits under the Income Tax Act of 1961.

The reason for applying the Equalization Levy to revenue is to simplify tax collection and compliance. Monitoring the profits of multinational digital companies like Amazon, with operations spanning various countries, would be complex for India. Therefore, the Equalization Levy serves as a direct tax, ensuring that revenue generated from Indian sources through digital services is subject to taxation in India.

Difference Between GAFA Tax and Equalisation Levy in India

Point of difference	GAFA Tax (Global Tax on Digital Giants)	Equalisation Levy
Definition	GAFA Tax refers to taxes specifically designed to target major digital corporations like Google, Apple, Facebook, and Amazon (hence GAFA).	The Equalisation Levy is a tax imposed on non-resident e-commerce operators for digital services provided in a country.
Purpose/Objective	Aims to ensure that tech giants pay a fair share of taxes in the countries where they have significant user bases but may not have a physical presence.	Intended to equalize the tax situation between foreign and domestic e-commerce companies and capture tax on digital transactions.
Primary Focus	Primarily focused on large technology companies with significant digital revenues.	Targets a broader range of digital services and e-commerce transactions.
Geographical Origin	Initiated by individual countries like France, aiming to tax profits made in their jurisdictions by large multinational tech companies.	Originating in India, it is designed to tax digital transactions involving foreign e-commerce companies.
Tax Base	Based on the revenues generated from digital services in a specific country.	Levied on the gross revenue from digital services provided by non-resident companies.
Rate of Taxation	Varies depending on the country implementing it. For example, France proposed a 3% tax rate.	In India, the rate is 2% on the revenues of select digital services.
Implementation	Implemented by individual countries according to their tax laws and regulations.	Implemented as part of the broader tax code of the country, like India's Finance Act.
Global Acceptance	The concept has faced opposition from some countries and tech companies, leading to discussions for a broader global solution under the OECD.	Mainly a country-specific measure, it has not been widely adopted or discussed in global tax reform debates like the OECD's initiatives.

Land Revenue is imposed under various State Government Acts. Typically, the determination of land revenue relies on the categorization of different land types and the monetary value of the average crop yield from the land. Various factors impacting the land's productivity in terms of value are considered, and the land revenue tax is assessed on a per-acre or per-hectare basis.

Property tax in India is applied to "real property," encompassing both land and the structures built upon it. The government evaluates the monetary worth of each property and calculates the tax based on its value. The revenue generated from this tax is allocated for the enhancement of local facilities, which includes activities such as road maintenance, park upkeep, and support for public schools. Property tax rates differ depending on the specific location and may vary from one city or municipality to another. Urban local authorities like municipal boards, municipal corporations, and town area committees are responsible for imposing property tax under the applicable statutes.

DIRECT TAX REFORMS

Direct Tax reform refers to bringing changes in taxation to maximize the government's revenue and reduce the burden of taxation on the people at the same time by ensuring an equitable, transparent, and fair taxation system.

India established the Tax Reforms Committee in 1991 under Dr. Raja Chelliah to implement the best strategy for expanding the base, cutting marginal tax rates, eliminating rate differentiation, simplification of the tax system, and increasing tax compliance. Subsequently, several committees and panels were appointed to reform the direct tax regime.

Need of Direct Tax Reforms in India

S. No.	Reason for tax reform	Explanation
1.	Broadening the Tax Base	A significant proportion of the Indian economy operates in the informal sector, leading to a narrow tax base. Tax reforms can help bring more entities under the tax net, thus enhancing revenue without increasing tax rates.
2.	Simplifying Tax Laws	The complexity of India's tax laws often leads to confusion and non-compliance. Simplifying these laws can help taxpayers understand their obligations better, leading to higher compliance rates.
3.	Reducing Litigation	India has a high number of tax disputes and litigations, which are time-consuming and costly. Reforms aimed at clarifying tax laws and dispute resolution mechanisms can reduce these litigations.
4.	Improving Compliance and Reducing Evasion	Reforms are needed to strengthen the enforcement mechanisms, enhance transparency, and leverage technology for better compliance.
5.	Encouraging Investments and Economic Growth	High corporate tax rates can discourage investment. Rationalizing tax rates and providing incentives for investments can stimulate economic growth and job creation.
6.	Aligning with International Standards	As global taxation norms evolve, particularly with measures against tax avoidance and profit shifting, India needs to align its tax laws with international practices to remain an attractive destination for foreign investment.
7.	Addressing the Digital Economy	The rise of the digital economy poses new challenges for taxation. India needs reforms to address these challenges and effectively tax digital transactions and entities.
8.	Equity and Fairness	A progressive tax system ensuring that the wealthy pay a fair share of taxes is crucial for social equity. Tax reforms can address issues of inequality in the current system.
9.	Administrative Efficiency	Streamlining tax administration, reducing red tape, and adopting advanced technology can make tax collection more efficient and reduce the cost of compliance for taxpayers.
10.	Environmental Considerations	Incorporating environmental concerns into the tax system, such as taxes on pollution or the use of non-renewable resources, can promote sustainable practices.
11.	Coping with Post-COVID Economic Challenges	In the post pandemic era, tax reforms can play a vital role in the economic recovery by stimulating demand and incentivizing businesses.

Various Direct Tax Reforms Undertaken in India

India has implemented various direct tax reforms over the years to modernize its tax system, enhance compliance, and make taxation more efficient and equitable. Some of these key reforms include:

- **Introduction of Goods and Services Tax (GST):** Although GST is an indirect tax, its introduction in 2017 was a significant reform that impacted the overall tax system, including direct taxes, by streamlining the tax structure and reducing the cascading effect of taxes.
- **Reduction in Corporate Tax Rates:** In 2019, the Indian government announced a significant reduction in corporate tax rates. For domestic companies, the rate was cut to 22% from 30%, and for new manufacturing companies, it was set at 15%, to boost economic growth and attract investments.
- **Implementation of the Direct Taxes Code (DTC):** The DTC was proposed to replace the existing Indian Income Tax Act of 1961. It aimed to simplify the language and structure of direct tax laws in India, although it has not been fully implemented yet.
- **Aadhaar-PAN Linking:** Linking the Aadhaar card (a unique identity number issued to Indian residents) with PAN (Permanent Account Number) cards was made mandatory to weed out fake PAN cards and to ensure a seamless tracking of financial transactions for tax purposes.
- **Faceless Assessment and Appeals:** To eliminate the interface between the taxpayer and the tax officer, reduce

harassment, and increase efficiency, the government introduced a faceless assessment and appeal system.

- **E-filing of Tax Returns:** The introduction of electronic filing of tax returns made the process faster, more convenient, and transparent, and it significantly increased compliance.
- **Advance Pricing Agreements (APA) and Transfer Pricing Regulations:** These were introduced to reduce litigation in cross-border transactions and provide clarity on transfer pricing matters, ensuring that multinational companies pay their fair share of taxes.
- **General Anti-Avoidance Rule (GAAR):** GAAR was introduced to curb aggressive tax planning and avoidance schemes that lack commercial substance.
- **Income Declaration Scheme and Black Money Act:** These initiatives aimed at unearthing undisclosed income and assets, allowing taxpayers to declare assets and pay taxes with a penalty, thereby bringing more wealth into the tax net.
- **Dividend Distribution Tax (DDT) Abolishment:** The abolition of the Dividend Distribution Tax in 2020 made dividends taxable in the hands of recipients, which was seen as a move to boost foreign investment.
- **Tax Incentives for Startups:** Special provisions and exemptions have been introduced to support startups, including tax holiday periods and easing of carry-forward of losses.
- **COVID-19 Relief Measures:** Temporary tax relief measures were introduced to support businesses and individuals during the COVID-19 pandemic, including extended filing deadlines and reduced interest rates on delayed payments.

These reforms reflect India's commitment to creating a more robust, transparent, and investor-friendly tax regime. The emphasis has been on simplifying tax laws, encouraging compliance, and aligning with global tax practices.

Rate of Growth of Taxes (%) Vs Growth in Nominal GDP

Year	Nominal GDP	Corporate Tax Growth	Growth in Income Tax	Tax Buoyancy
2021-22	19.5	55.6	43	2.52
2022-23	15.4	16	20	1.1
2023-24 (Apr-Aug)	8	15	35.7	—

India's Gross Direct Tax Collections of Rs. 19,72,248 crore in F.Y. 2022-23 have registered an increase of over 173.31% compared to Gross Direct Tax Collections of Rs. 7,21,604 crore in F.Y. 2013-14. Direct Tax to GDP ratio has increased from 5.62% in F.Y. 2013-14 to 6.11% in F.Y. 2022-23.

Indirect Taxes

- **Excise duty** used to be applied to manufactured goods, with taxation occurring when the goods left the factory premises
- **Customs duty** is imposed on the import and export of commodities.
- **Service Tax** was levied on the provision of services.
- **Central Sales Tax (CST)** was imposed by the Central government on the sale of products between different states. However, the tax revenue was collected and retained by the state where the transaction originated, which is why it was referred to as an origin-based tax.

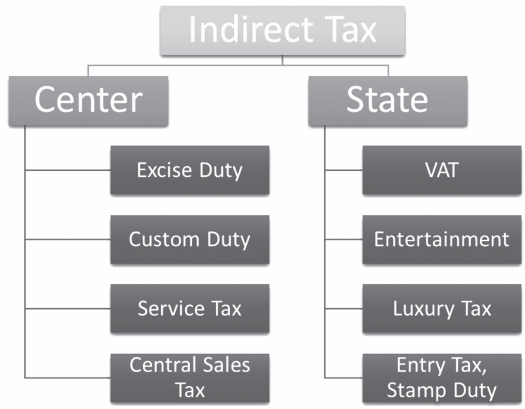


Fig. 9.9

- **Value Added Tax (VAT)** was applied to the sale of goods within a state. The Central government did not have the authority to tax intrastate sales, and VAT was only imposed on the value added at each stage of production. Under the VAT system, every entity in the value chain was required to remit taxes to the government based on their respective value additions.
- **Entry Tax**, previously enforced by Indian state governments, applied to the inter-state movement of goods. It was imposed by the receiving state to safeguard its tax revenue base
- **Stamp Duty** is a tax that pertains to all legal property transactions. It required the affixing or imprinting of a physical stamp on the document to signify payment of the stamp duty. As it is imposed by individual states, the tax rate varies from one state to another.

Goods and Services Tax (GST)

Goods and Services Tax (GST) was introduced on **July 1, 2017,** as a significant tax **reform** aimed at **simplifying and unifying** the country's complex **indirect tax system**. The Indian GST system is based on the **principles of value-added tax** and applies **to the supply of goods and services across the nation.** Here are some key aspects of GST in India:

- **Multiple Tax Levels:** India's GST system consists of multiple tax rates, with four primary tax rates (5%, 12%, 18%, and 28%), along with a few special rates for specific goods and services. Additionally, there is a "zero rate" for certain essential goods and services.
- **Destination-Based Tax:** Similar to most GST systems worldwide, India's GST is a destination-based tax. This means that the revenue generated from GST is collected by the state where the goods or services are consumed, rather than where they are produced.

- **Input Tax Credit:** Under the Indian GST system, businesses can claim input tax credit for the GST they paid on their purchases. This helps eliminate the cascading effect of taxation and ensures that taxes are levied only on the value added at each stage of the supply chain.
- **Threshold Exemptions:** Small businesses with an annual turnover below a certain threshold are exempt from GST registration and collection, which eases the compliance burden for micro and small enterprises.
- **Composition Scheme:** India's GST system includes a composition scheme for small businesses with a turnover up to a specified limit. Businesses under this scheme can pay GST at a lower rate and have simplified compliance requirements.
- **Compliance and Reporting:** Registered businesses in India are required to file regular GST returns, including details of their sales, purchases, and tax liabilities, through an online portal provided by the Goods and Services Tax Network (GSTN).
- **Goods and Services Categorization:** GST in India classifies goods and services into various tax slabs based on their nature and essentiality. This categorization is periodically reviewed and updated by the GST Council, a body consisting of representatives from both the central and state governments.
- **Anti-Profiteering Authority:** India also has an Anti-Profiteering Authority in place to ensure that businesses pass on the benefit of reduced tax rates or input tax credits to consumers by reducing prices. It has now subsumed with competition commission of India.

GST has had a significant impact on India's economy, leading to greater transparency, reducing tax evasion, and promoting a formalized economy. However, its implementation has not been without challenges, including adapting to the multiple tax rates and addressing compliance issues. The Indian government continues to refine and streamline the GST system to make it more efficient and business-friendly.

Indirect Tax System Before The Introduction of GST

Before the introduction of Goods and Services Tax (GST) in India on July 1, 2017, the country had a complex system of indirect taxation. The Central government imposed its own set of indirect taxes, such as Service Tax and Excise Duty, while State governments levied taxes like Value Added Tax (VAT) and Entertainment Tax. This dual taxation system created several issues for businesses and the overall economy.

- **Double Taxation:** When a producer manufactured a product, they were required to pay both Central Excise Duty and State VAT. This resulted in a situation where the tax was levied on top of another tax, leading to a cascading effect. As a result, the final product became more expensive in the market.
- **Lack of Interstate Credit:** Under the previous system, businesses were unable to offset the taxes paid in one state against their tax liability in another state. This lack of cross-state credit further complicated the tax structure and increased the cost of doing business across state borders.
- **Diverse Tax Rates:** Different states in India had varying VAT rates, ranging from 1% to 20%. Additionally, they provided exemptions on different categories of products. This non-uniformity in tax rates created a situation where the effective tax on the same goods and services differed from state to state.
- **Market Fragmentation:** The diverse tax structure fragmented India into a heterogeneous market. This fragmentation not only made it challenging for businesses to operate efficiently but also hindered investment and economic growth.

In summary, the pre-GST era in India was characterized by a complex and fragmented tax system with multiple layers of taxation, a lack of credit across states, and varying tax rates. The implementation of GST aimed to address these issues by introducing a unified tax regime that simplified the tax structure, eliminated double taxation, and created a more uniform tax system across the country.

Constitutional and Legislative Framework of GST

The Constitution (One Hundred and First Amendment) Act, 2016, is a significant reform in the Indian tax system. This amendment introduced the Goods and Services Tax (GST) in India.

The Key Highlights of The 101st Constitutional Amendment Act are

- **Introduction of GST:** The act brought in a uniform tax system by subsuming various central and state taxes into a single GST.
- **Dual GST Model:** It implemented a dual GST model, which means that both the Centre and the States will simultaneously levy GST on a common tax base.
- **GST Council:** The amendment led to the formation of the GST Council, a joint forum of the Centre and the States. This council is tasked with making recommendations on various issues related to GST, such as the tax rate, exemption list, and threshold limit.
- **Integrated GST (IGST):** The act also introduced the concept of Integrated GST, which is levied on inter-state transactions of goods and services and is shared by both the Centre and the States.
- **Compensation to States:** It provided for compensation to states for any revenue loss due to the implementation of GST for a period of five years.

IGNITE YOUR MIND

Do you think the emphasis on Aadhaar-PAN linking is an effective strategy for curbing tax evasion and ensuring transparency in financial transactions? What potential challenges or concerns might arise from such mandatory linking?

Amendments to the Constitution by 101st Constitutional amendment act, 2016

Articles Added	Articles Amended
Article 246A: Grants both the Parliament and state legislatures the power to make laws with respect to GST. However, only the Parliament has the exclusive power to make laws on inter-state trade or commerce.	**Article 248:** The scope of the residual legislative power of Parliament was amended to clarify that Parliament has exclusive power to make laws with respect to GST where the supply of goods or services or both takes place in the course of inter-state trade or commerce.
Article 269A: GST on supplies in the course of inter-state trade or commerce shall be levied and collected by the Government of India and such tax shall be apportioned between the Union and the States in the manner provided by law based on the recommendations of the GST Council.	**Article 249:** This amendment enables the Parliament to legislate with respect to a matter in the State List in the national interest, provided that the Rajya Sabha passes such a resolution by a two-thirds majority
Article 279A: Establishes the Goods and Services Tax Council, which will be a joint forum of the Centre and the States. This council is tasked with making recommendations to the Union and the States on various issues related to GST.	**Article 250:** It was amended to allow the Parliament to legislate with respect to GST during an emergency period
Articles Deleted **Article 268A:** This article, which dealt with the Service Tax, was deleted	**Article 268:** Amended to clarify that certain duties levied by the Union but collected and appropriated by the States are outside the purview of GST.
	Article 271: It was amended to clarify that no surcharge shall be levied on goods and services under the GST regime.
Schedules Amended **Seventh Schedule:** The Union List (List-I) and the State List (List-II) were amended to accommodate the new tax structure.	

GST Council

The Goods and Services Tax (GST) Council in India plays a pivotal role in the governance and administration of GST, the comprehensive indirect tax levy on goods and services across the country. **Here's an overview of its composition and functions:**

Functions of the GST Council

- **Recommendations on GST Laws:** The Council makes recommendations to the Union and the States on various aspects of GST, such as the goods and services that may be subjected or exempted from GST.
- **GST Rate Structure:** It decides the rate structure of GST, which includes the rates of GST, the threshold limit for exemption, and the limits for turnover for availing the composition scheme.
- **Special Provisions for States:** The Council recommends special provisions

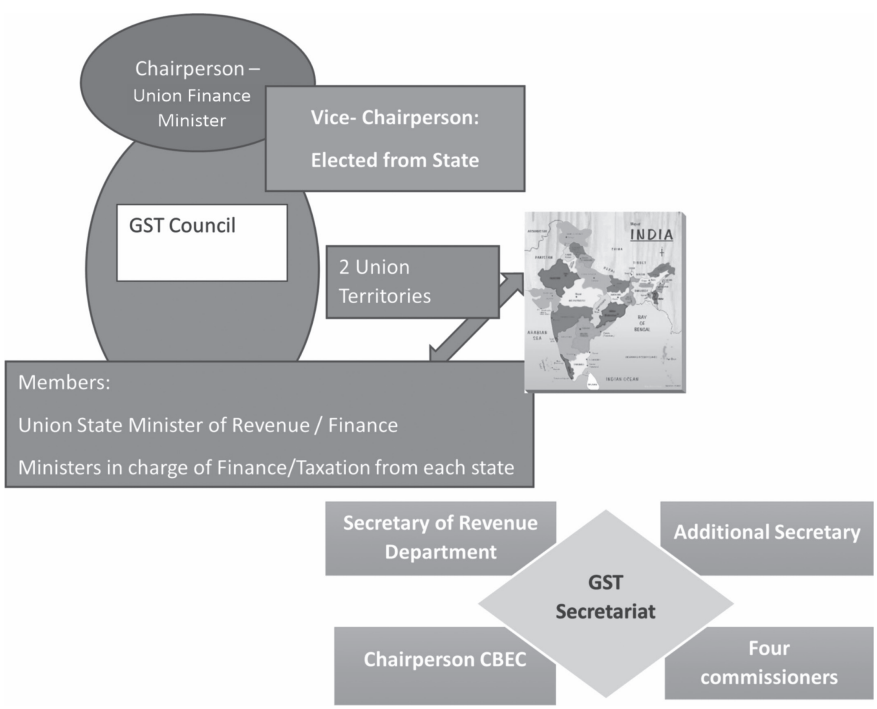


Fig. 9.10: Composition of The GST Council

for certain states, mainly the North-Eastern States, Jammu & Kashmir, Himachal Pradesh, and Uttarakhand.

- **Model GST Laws:** The drafting of model GST laws, the principles of levy, apportionment of IGST (Integrated Goods and Services Tax), and the principles that govern the place of supply fall under the purview of the Council.
- **Dispute Resolution:** It also functions as a dispute resolution mechanism, resolving any disputes arising out of its recommendations.
- **Other Recommendations:** The Council also makes recommendations on various other aspects related to GST, such as the date on which GST will be levied on petroleum crude, high-speed diesel, motor spirit (petrol), natural gas, and aviation turbine fuel.
- **Special Attention to Small Businesses:** It pays special attention to issues and concerns of small businesses and tries to ensure that GST does not become a burden for them.
- **Periodic Review:** The Council periodically reviews the tax regime to make it more efficient and to meet the changing economic needs.

Quorum, Decision-Making Process, Weightage of Votes, and Validity of Acts

- **Quorum Requirement:** A minimum of 50% of the total members of the GST Council must be present to constitute a valid meeting.
- **Decision-Making Majority:** For any decision to be passed during the meeting, it must be supported by at least a 75% majority of the weighted votes of the members who are present and voting.
- **Weightage of Votes:**
  - The vote of the Central Government carries a weight of one-third of the total votes.
  - The collective votes of the State Governments carry a weight of two-thirds of the total votes.
- **Validity of Acts:**
  - The validity of any act, decision, or proceeding of the GST Council is not affected by any vacancy within the Council.
  - Any defects in the Council's constitution or in the appointment of its members do not invalidate its decisions.
  - Non-compliance with procedural aspects does not render the Council's decisions or proceedings invalid.

Supreme Court Judgment of May 2022 Regarding The GST Council

- **Nature of GST Council's Recommendations:** GST Council's recommendations are advisory and are not obligatory for the Union and the State governments.

Fig. 9.11

- **Legislative Authority on GST:** Both the Parliament and the State Legislatures hold concurrent powers to legislate on matters related to GST.
- **Scope of Binding Recommendations:** The GST Council's recommendations are binding on the government only for secondary or subordinate legislation, such as modifications in tax rates or the formulation of rules under the CGST, SGST, and IGST Acts. However, for primary legislation (like amendments to the CGST, SGST Acts), these recommendations are merely influential and not mandatory.

The Electronic Way Bill (E-Way Bill)

The Electronic Way Bill (E-Way Bill) is an important component of the Goods and Services Tax (GST) system in India. It's a digital document generated on the GST portal, evidencing the movement of goods. Here are the key aspects of the E-Way Bill under GST:

Purpose: To Track the Movement of Goods as it is primarily used to monitor the movement of goods from one place to another.

Value Threshold: An E-Way Bill is required when the value of the consignment of goods transported exceeds ₹50,000 (although this threshold can vary in some states).

Interstate and Intrastate Movement: It's necessary for both interstate and intrastate movement of goods.

The validity of an E-Way Bill: Depends on the distance the goods have to travel. For example, for every 100 km or part thereof, the E-Way Bill is valid for one day in case of regular cargo, and for 15 km in case of Over Dimensional Cargo (ODC).

Key Features

- **Real-Time Tracking:** Authorities can track the movement of goods in real-time through the E-Way Bill.
- **Reduction in Transit Time:** It helps in reducing delays at check posts and minimizes transit time.
- **Integration with Transport Systems:** The system is designed to be integrated with various transport systems and toll booths for easier movement of goods.
- **Tax Compliance:** It aids in ensuring tax compliance as it details the transactions and movement of goods.
- **Prevention of Tax Evasion:** By monitoring the movement of goods, it helps in preventing tax evasion.

The E-Way Bill system under GST represents a significant move towards digitizing business processes and ensuring transparency and efficiency in the movement of goods across India.

GOODS AND SERVICES TAX NETWORK (GSTN)

The Goods and Services Tax Network (GSTN) is a digital and technological backbone that facilitates the implementation and monitoring of the Goods and Services Tax (GST) in India. GSTN provides a shared IT infrastructure and services to central and state governments, taxpayers, and other stakeholders, helping in the efficient and transparent administration of GST.

The platform helps taxpayers in preparing, filing returns, making payments, and complying with indirect tax regulations.

Ownership and Registration of GSTN

GSTN is a not for profit, limited by shares, Government Company. It was incorporated in 2013 under Section 25 of the Companies Act, 1956 (Now Section 8 of the Companies Act, 2013). The company is headed by a chairman who is appointed by the Government.

The Board of GSTN in its **49th Board Meeting** approved the conversion of GSTN into a **Government Company and hence 100%** of the shareholding being held by the Government (**50% with the Union** Government and **50% jointly with State Governments & UTs**) in GSTN.

Key Features of The Gstn Include

- **Registration:** It allows new businesses to register for GST and existing businesses to migrate to the GST system.
- **Tax Return Filing:** GSTN enables the electronic filing of GST returns, making the process efficient and paperless.
- **Tax Payment:** It facilitates the online payment of GST liabilities.
- **Input Tax Credit:** GSTN simplifies the process of claiming and verifying input tax credits.
- **Compliance Tracking:** It assists in tracking compliance levels of registered businesses.
- **Data and Analytics:** GSTN uses data analytics to prevent tax evasion and improve compliance.

GSTN also acts as a repository of all GST-related information, making the tax system more transparent and accountable. It's a critical component in ensuring the success of the GST regime in India, by simplifying and standardizing the indirect tax framework.

The Composition Levy Under The GST Regime

It is an alternative tax method tailored for smaller businesses and is designed to simplify tax procedures and reduce compliance costs for eligible enterprises.

Overview of Composition Levy

The Composition Levy is a simplified tax regime aimed at small businesses with an annual turnover of up to ₹ 1.5 crore. This scheme's primary goal is to make tax compliance less complex and more cost-effective for small-scale businesses.

This scheme is particularly advantageous for small businesses that find it challenging to comply with the regular GST requirements due to resource constraints. By opting for the Composition Levy, these businesses can benefit from a simpler tax process and potentially lower tax liabilities.

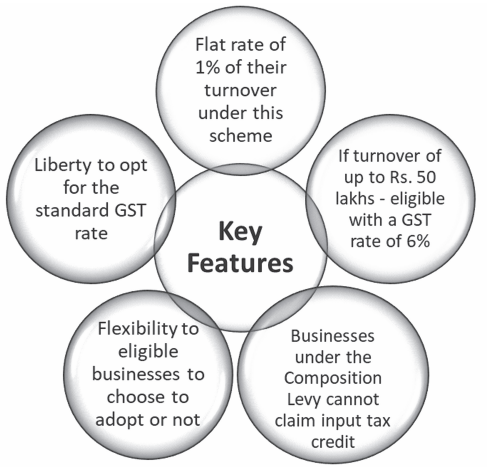

Flat rate of 1% of their turnover under this scheme
Liberty to opt for the standard GST rate
If turnover of up to Rs. 50 lakhs - eligible with a GST rate of 6%
Key Features
Flexibility to eligible businesses to choose to adopt or not
Businesses under the Composition Levy cannot claim input tax credit

Fig. 9.12

Input Tax Credit (ITC) Mechanism

The ITC mechanism aims at streamlining the taxation system and preventing the cascading effect of taxes. It allows registered businesses to offset the tax paid on their purchases (input tax) against the tax they collect on their sales (output tax). This mechanism ensures that businesses only pay tax on the value they add to a product or service and not on the taxes already paid by their suppliers.

To avail of ITC, businesses must adhere to specific conditions, such as obtaining proper tax invoices from their suppliers, ensuring that the supplier is GST registered, and confirming that the taxes paid on these invoices are deposited with the government.

By following the ITC procedure, businesses can not only reduce their tax liability but also promote transparency in the tax system, ultimately benefiting both businesses and consumers.

The GST Compensation Cess

The GST Compensation Cess was introduced **as a response to state governments' concerns regarding potential revenue losses** following the implementation of the Goods and Services Tax (GST).

Background and Purpose

1. **Revenue Concerns of States:** Prior to the GST rollout, states were apprehensive about potential drops in their tax revenues and the loss of autonomy in imposing additional taxes under the new regime.
2. **Revenue Growth Calculation:** The Indian Government analyzed the growth of states' indirect tax revenues from **2012-13 to 2015-16, observing an average annual growth rate of 14%.**

Government's Assurance: The Central Government assured that if a state's indirect revenue growth fell **below 14% annually from the 2015-16 base year,** it would compensate for the shortfall.

Implementation Mechanism: The Government enacted the Goods and Services Tax (Compensation to States) Act, 2017. A GST Compensation Cess was imposed on luxury and demerit goods, with the proceeds earmarked for compensating states.

Collection and Allocation of Cess: The cess is collected into the Consolidated Fund of India, and then transferred to the "GST Compensation Fund" under the Public Account of India.

Fund Distribution: From there, it's allocated to the state governments.

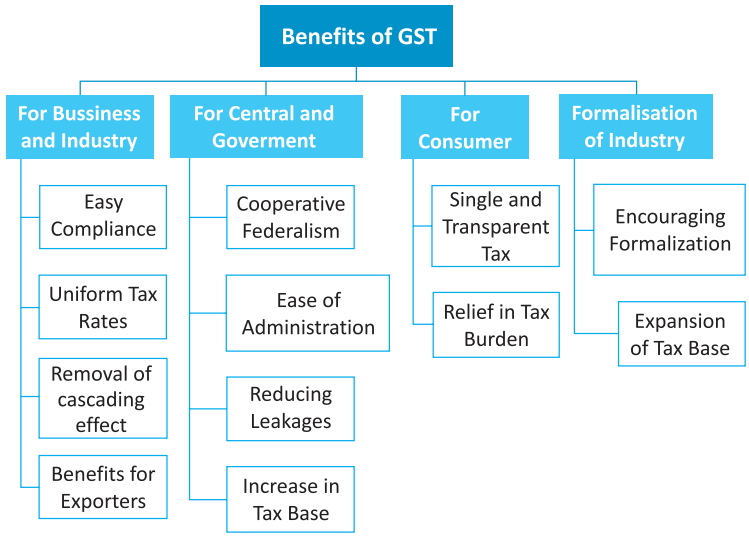


Fig. 9.13

Issues During COVID-19

- **Increased Shortfall:** The pandemic led to a significant shortfall in revenues, making it infeasible to solely rely on increasing the cess.
- **Resolution Strategy:**
  - The Central Government decided to borrow the shortfall amount attributable to COVID-19 and transfer it to states on a 'back-to-back' basis.
  - States will eventually repay the principal and interest.

Repayment of Borrowed Amounts

- **Extended Cess Collection:** To facilitate the repayment of these loans, The cess collection has been extended beyond its original end date of June 30, 2022, to March 31, 2026.
- **Specific Use of Extended Cess:** This extension is specifically for repaying the principal and interest of the borrowed amounts.

Currently, while states advocated for a general extension of the cess for an additional five years from July 2022, the Central Government limited the extension to cover only the COVID-related borrowings.

This approach balances the immediate financial needs of the states due to the pandemic-induced revenue shortfall with the long-term fiscal strategy of the GST regime.

Assessment and Evaluation of 6 years of GST

GST completed 6 years on 1st of July 2023. The growth of GST has been phenomenal in terms of collection which have grown from ₹ **7.19 lakh crore in FY 2017-18** (from July 2017) to ₹ **18.10 lakhs crore in FY 2022-23.**

The collection for **FY 2022-23 was 22% higher than that of FY 2021-22**.

GST since inception has seen various changes with respect to **policy, rate rationalization, procedural compliance** and many more. GST has also withstood the Covid pandemic. The continuous and unwavering effort from the government, industry and tax experts have contributed to the success of GST. With this, we recap the major impact of GST from the last six years and the issues and expectations of the trade ahead.

Positive Impact

1. **Achievement of "One Nation One Tax" Goal:** GST has brought uniform taxation, ensuring seamless transfer of goods and services across all jurisdictions.
2. **Robust Technological Infrastructure:** Continuous updates to the system have led to the digitization of records and seamless information flow across various government departments.
3. **Data Analytics and AI Utilization:** Early detection of fake entities and tax evasion, along with quick processing of GST refunds.
4. **Increased Taxpayer Base:** Efficient tax administration and technology use have expanded the taxpayer base, leading to higher GST collections year over year.
5. **Regular GST Council Meetings:** Periodic review and timely resolution of issues faced by taxpayers and stakeholders.

Issues and Expectations

1. **Need for Rate Rationalization:** Suggestion to consolidate into fewer and lower tax slabs due to increased GST collections and broader tax base.
2. **Centralized Assessment for Large Taxpayers:** Addressing the challenge of multi-state assessment and duplicity, proposing centralized assessment.
3. **Uniformity in Allocation of Common Costs:** Establishing clear tax policies for determining the value of such supplies.

4. **Input Tax Credit (ITC) Provisions:** Addressing the blockage of working capital due to strict ITC restrictions based on supplier compliance.
5. **Non-Formation of GST Appellate Tribunal:** Delay in setting up a tribunal has led to a backlog of litigation matters.
6. **Inclusion of Petroleum Products in GST:** A long-standing desire of the trade, still not under consideration.
7. **Amnesty for Pending Litigations:** A one-time amnesty is sought for closing pending litigations due to unintentional errors and misinterpretations in the initial phase of GST.

IGNITE YOUR MIND

In the context of the current global economic slowdown, do you think the Indian government should consider revisiting the existing GST rate structure to provide stimulus to businesses and boost economic growth? If so, which sectors or specific aspects of the tax system would you prioritize for reform?

Overall Perspective

- GST's role is significant in India's position as the fifth-largest economy in the world.
- The taxation system underpins consistent revenue, economic growth, and industrial activity.
- Balancing taxpayer expectations with government efforts is key for further simplifying GST and enhancing ease of doing business.

TAX EVASION

Tax evasion is the illegal practice of not paying taxes, by individuals, companies, trusts, and other entities. It often involves deliberately misrepresenting or concealing information to the tax authorities to reduce tax liability. This can include dishonest tax reporting, such as declaring less income, profits or gains than the amounts actually earned, or overstating deductions.

Forms of Tax Evasion

1. **Underreporting Income:** Not declaring all income sources or declaring less income than actually earned.
2. **Inflating Deductions:** Overstating expenses or deductions to reduce taxable income.
3. **Hiding Money, Income, or Assets:** Using offshore accounts or other means to conceal income or assets.
4. **Using Fake Documents:** Creating false invoices or documents to justify false deductions or credits.
5. **Illegal Activities:** Earning income through illegal activities and not reporting it.

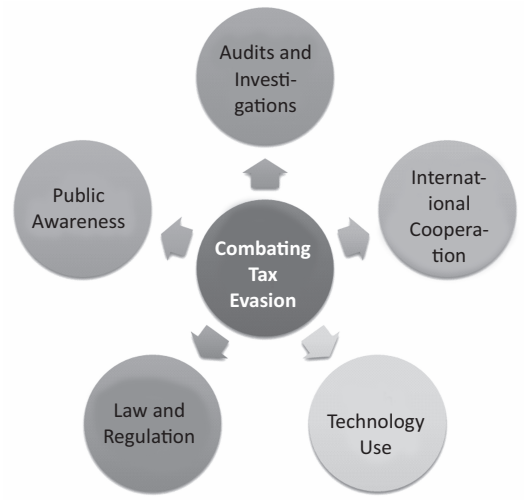


Fig. 9.14

Tax Evasion "Surrender" Schemes

Tax evasion "surrender" schemes, means tax amnesty schemes, have been periodically introduced by the government.

Key Features of Tax Amnesty Schemes

1. **Voluntary Disclosure:** Taxpayers are encouraged to voluntarily disclose hidden income or assets.
2. **Incentives:** Reduced penalties, immunity from prosecution, or favorable tax rates are offered.
3. **Limited Period Offer:** These schemes are usually available for a limited period.
4. **Revenue Generation:** Aimed at bringing undisclosed income into the tax net, thereby increasing revenue.
5. **Legal Framework:** Governed by specific laws or provisions enacted for the scheme.

Related Schemes in India

1. **Voluntary Disclosure of Income Scheme (VDIS) 1997:** One of the most famous amnesty schemes, allowing taxpayers to disclose undisclosed income with assurance of confidentiality and immunity from penal consequences.
2. **Income Declaration Scheme (IDS) 2016:** Launched post the demonetization move, this scheme allowed the declaration of undisclosed income with a tax payment of 45%.
3. **Pradhan Mantri Garib Kalyan Yojana (PMGKY) 2016:** Post-demonetization scheme for declaring unaccounted wealth with a tax and penalty of 50%, and mandatory deposit of 25% of the undisclosed income in an interest-free deposit for four years.
4. **Direct Tax Vivad se Vishwas Act, 2020:** Aimed at reducing litigation, this scheme allowed taxpayers to settle tax disputes by paying the disputed tax and getting a complete waiver on interest and penalty.

The Vivad Se Vishwas Scheme (VSV Scheme)

It is an initiative aimed at resolving pending and disputed direct tax cases quickly and effectively. This scheme provides an opportunity for taxpayers to settle their outstanding taxes with certain concessions.

Key Aspects of The Vsv Scheme Include

1. **Target Audience:** The scheme is beneficial for individuals and entities with tax disputes in various forums, including the Supreme Court, High Courts, Income Tax Appellate Tribunals, and Commissioner of Appeals.
2. **Resolution of Disputes:** It aims to resolve a substantial number of pending tax disputes, approximately 483,000 cases, related to direct taxes.
3. **Concessions on Penalties and Interest:** The scheme offers a waiver of interest and penalty for those who clear their pending taxes by March 31st.
4. **Extended Deadline with Additional Charge:** For taxpayers unable to pay by March 31st, there is an option to pay by June 30th, but with an additional 10% on the tax amount.
5. **Provision for Disputed Interest and Penalty:** If the dispute involves interest and penalty, taxpayers are required to pay only 25% of the disputed amount by March 31st, which increases to 30% if extended to June 30th.

This scheme is designed to ease the burden of prolonged tax litigation for taxpayers and help the government clear the backlog of unresolved tax dispute

Differences Between Tax Evasion and Tax Avoidance

Criteria	Tax Evasion	Tax Avoidance
Definition	The illegal practice of not paying taxes that are legally due.	Utilizing legal methods to minimize tax liability within the framework of Indian tax laws.
Legality	Illegal and subject to legal penalties.	Legal and complies with the law.
Methods	Underreporting income, inflating expenses, concealing assets, or using false documents.	Utilizing deductions, exemptions, and incentives provided under the Income Tax Act
Consequences	Leads to penalties, fines, and possible imprisonment.	No legal consequences, but might face ethical scrutiny if it involves aggressive tax planning.
Intent	Deliberate intention to deceive tax authorities and reduce tax liability unlawfully.	Using the tax system legally to reduce tax burden without deceit.
Example	Not reporting cash transactions or income from property or business.	Investing in tax-saving schemes like Public Provident Fund (PPF), National Pension System (NPS), or utilizing home loan interest deductions.
Government Response	Enforcement through audits, investigations, and legal action by the Income Tax Department.	Periodic amendments to tax laws to close loopholes and discourage aggressive tax planning.
Perception	Viewed as unethical and harmful to the country's fiscal health.	Generally seen as smart financial planning, but can be controversial if it involves very aggressive strategies.

Double Taxation Avoidance Agreement (DTAA)

A Double Taxation Avoidance Agreement (DTAA) is a treaty signed between two or more countries to avoid the situation where the same income is taxed by two or more jurisdictions. The main purpose of DTAA is to make a country an attractive investment destination by providing relief on dual taxation. This relief is provided by exempting income earned abroad from tax in the resident country or by providing credit to the extent taxes have already been paid abroad.

Key Features of DTAA

Elimination of Double Taxation	DTAA helps in avoiding the tax being paid twice on the same income. This is done either through the **'Exemption Method'** (income is taxed in one country and exempt in another) or the **'Tax Credit Method'** (where the income is taxed in both countries but credit for tax paid in one country is given in the other).
Reduced Tax Rates	DTAAs provide for **reduced rates of taxation on dividends, interest, royalties, and other forms of income.**

Prevention of Fiscal Evasion	DTAAs also include provisions for the **exchange of information between tax authorities** of the contracting states, which helps in preventing tax evasion.
Mutual Agreement Procedure (MAP)	This is a **dispute resolution mechanism** within DTAAs which allows authorities of the contracting states to resolve any difficulties or doubts arising as to the interpretation or application of the treaty.
Permanent Establishment	DTAAS define the concept of a **'permanent establishment'**, which is crucial in determining where a company's profits are taxed.
Residency	These agreements also establish criteria to determine the **residency status of a taxpayer** to ascertain their tax liability.

Countries enter into these agreements to encourage foreign investment by providing predictable tax regimes and reducing taxation burdens. The specific provisions and benefits of a DTAA vary depending on the countries involved and the individual agreements they have negotiated.

DTAA AND INDIA

DTAA and India's Engagement

India's proactive engagement with Double Taxation Avoidance Agreements (DTAAs) is evident through its extensive network and ongoing efforts to update these agreements. **Here are some notable actions and examples illustrating India's approach:**

- **Broad DTAA Network:** India has one of the largest networks of DTAAs, with agreements in place with over **90 countries**. Examples include DTAAs with major economies like the **United States, the United Kingdom, Japan, Germany, and Singapore.**
- **Renegotiations for Updating Agreements:** India has renegotiated DTAAs with several countries to reflect current economic scenarios. For instance, the **India-Mauritius DTAA**, originally signed **in 1983, was amended in 2016 to curb tax evasion** and prevent misuse of the treaty.
- **Incorporating Anti-Abuse Provisions:** India's newer DTAAs often include clauses to prevent treaty abuse. The **India-Singapore DTAA,** for example, includes a Limitation of Benefits clause similar to the one in the India-Mauritius treaty.
- **Adoption of Multilateral Instrument (MLI):** India joined the **MLI in 2017**, which allows it to **implement Base Erosion and Profit Shifting (BEPS)** measures across its DTAA network. This is a significant step towards preventing tax avoidance and aligning India's treaties with international standards.
- **Exchange of Information:** India's commitment to transparency is reflected in its agreements for the exchange of information, such as the agreement with **Switzerland, enhancing cooperation in tax matters and tackling black money** stashed abroad.

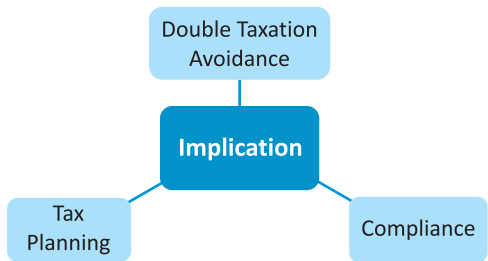


Fig. 9.15

- **Improving Dispute Resolution:** The introduction of **Mutual Agreement Procedures (MAP)** in DTAAs, like the one with the **Netherlands**, helps in resolving tax disputes more effectively.
- **Digital Taxation Initiatives:** India's introduction of the **Equalisation Levy,** although not part of DTAAs, is a significant step in taxing digital economy transactions, supplementing its DTAA framework.
- **Facilitating Foreign Investments:** The **India-Netherlands DTAA,** for instance, provides favorable tax treatment on dividends and royalties, making India an **attractive destination for Dutch investors.**
- **Harmonizing Domestic Laws:** India regularly updates its domestic tax laws to align with DTAA provisions, as seen in the amendments following the Mauritius treaty revision.
- **Addressing Challenges in Digital Economy:** The **India-France DTAA** is an example where **discussions have been ongoing** to address the challenges posed by the digital economy and ensure fair taxation of digital companies.

These actions and agreements highlight India's commitment to creating a fair, transparent, and stable international tax framework, which is crucial for attracting foreign investment and fostering economic growth.

Place of Effective Management

"Place of Effective Management" (POEM) is a concept used in tax law to determine the tax residency of a company. It plays a crucial role in deciding which country has the right to tax a company's income.

This concept is particularly important in the context of international taxation and is used to prevent tax evasion through the use of **shell companies** or other means of shifting profits to low-tax jurisdictions.

Definition: POEM is defined as the place where key management and commercial decisions necessary for the conduct of the business of an entity as a whole are, in substance, made.

Key Aspects of POEM

1. **Tax Residency:** Under POEM, a company is considered a tax resident in the country where its real and substantial management activities are carried out, irrespective of where it is incorporated.
2. **Decision-Making:** The focus is on where the strategic, significant, and commercial decisions that affect the company's affairs are actually made.

Implementation in India
The Finance Act 2015 introduced POEM as a test for determining the residency of foreign companies with effect from April 1, 2016. According to Indian tax laws, a foreign company is considered a tax resident in India if its POEM is in India.
Guidelines: Tax authorities have issued guidelines to provide clarity on the application of the POEM criteria, considering factors like the location of Board meetings, executive committee meetings, and where the company's senior management is based.

Base Erosion & Profit Shifting and OECD Framework

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies used by multinational enterprises (MNEs) to exploit gaps and mismatches in tax rules across different jurisdictions. The goal of these strategies is to artificially shift profits from higher-tax jurisdictions to lower-tax jurisdictions or tax havens, where there is little or no economic activity by the company. This shifting results in eroding the tax base of the higher-tax jurisdictions and leads to minimal overall corporate tax being paid globally.

The Core Aspects of BEPS

1. **Profit Shifting:** Transferring profits to low-tax jurisdictions from countries where the actual business activities and value creation occur.
2. **Tax Base Erosion:** Reducing the taxable income in a jurisdiction through deductions such as interest, royalties, and service fees paid to related entities in low-tax jurisdictions.
3. **Exploiting Loopholes:** Utilizing differences in tax laws and treaties between countries to reduce tax liabilities.
4. **Transfer Pricing Manipulation:** Setting prices for transactions between group companies in different countries to shift profits to low-tax jurisdictions.
5. **Tax Treaty Abuse:** Utilizing tax treaties to obtain reduced withholding tax rates or avoid taxation in certain situations which were not intended under the treaty.

BEPS practices have raised significant concerns globally as they lead to substantial tax revenue losses for governments, distort competition, and undermine the integrity of tax systems. To address these challenges, the **Organisation for Economic Co-operation and Development (OECD)** and the **G20** initiated a project to develop a **coordinated international approach to combat BEPS.** This project has produced a set of guidelines and recommendations known as the BEPS Action Plan, aiming to realign taxation with substance and value creation, increase transparency, and improve the coherence of international tax rules.

BEPS IN INDIAN CONTEXT

Base Erosion and Profit Shifting (BEPS) in the context of India reflects the country's active engagement and response to the global challenge of tax avoidance by multinational enterprises (MNEs). India, as a member of the G20 and participant in the OECD/G20 Inclusive Framework on BEPS, has been a vocal advocate for stronger international tax rules to prevent BEPS.

India's approach to BEPS

Adoption of BEPS Action Plan	India has been proactive in implementing the BEPS Action Plan, adopting various measures outlined in the 15-action initiative. These measures aim to address issues like transfer pricing, digital taxation, and tax treaty abuse.
Digital Taxation	India introduced the Equalisation Levy, often referred to as the "Google Tax," to tax digital transactions and services provided by non-resident e-commerce companies. This move was partly in response to BEPS Action 1, which deals with the tax challenges of the digital economy.
Transfer Pricing Rules and Documentation	India has tightened its transfer pricing regulations, aligning them with **BEPS Action 13.** This action focuses on enhancing transparency, including the introduction of **Country-by-Country Reporting (CbCR)** for large multinational groups.
Multilateral Instrument (MLI)	India has **signed the MLI**, which is a **legal instrument** developed as part of the BEPS project to enable countries to swiftly modify their bilateral tax treaties to implement BEPS measures, particularly those related to **preventing treaty abuse and artificial avoidance of permanent establishment status.**

Prevention of Treaty Abuse	In line with **BEPS Action 6**, India has been **renegotiating its double taxation avoidance agreements (DTAAs)** with several countries to include provisions to prevent treaty shopping and ensure that tax treaties do not inadvertently facilitate profit shifting.
Domestic Anti-Avoidance Rules	India has implemented **General Anti-Avoidance Rules (GAAR)** to **curb aggressive tax planning strategies** that lack commercial substance.
Participation in Global Tax Discussions	**India actively participates in international discussions** for a consensus-based solution on the taxation of the digital economy under the **OECD framework.** This includes engagement in the two-pillar approach to address the broader challenges posed by the digitalization of the economy.

India's response to BEPS demonstrates its commitment to aligning with global tax reforms while also addressing the unique challenges faced by its economy. The goal is to ensure a fair and transparent tax system that minimizes revenue loss and creates an equitable environment for domestic and international businesses.

Organization for Economic Co-operation and Development (OECD)

Year of Formation: 1961

Number of Member Countries: 38

Primary Objective: To promote policies aimed at improving the economic and social well-being of people globally.

Headquarters: Paris, France

Role and Functions:

- Acts as a global think tank, gathering data and analyzing economic, social, and environmental trends.
- Makes policy recommendations on a variety of topics, including economic development, education, employment, and healthcare.
- Publishes respected economic reports, statistics, and guidelines.

Global Influence:

- Maintains high standards of living and financial stability among member nations.
- Contributes to global trade and economic growth.
- Influential in shaping global policies and setting international standards across various sectors.

India Joined OECD/G20 Inclusive Framework Tax Deal

In 2021, India and the majority of the members of **OECD-G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS)** have joined a new **two-pillar plan** to reform international taxation rules.

The two-pillar plan – **inclusive framework tax deal on Base Erosion and Profit Shifting (BEPS)-** seeks to **reform international tax rules** and ensure that multinational enterprises pay their fair share wherever they operate.

India's position: India will have to roll back the equalization levy that it imposes on companies such as Google, Amazon and Facebook when the global tax regime is implemented.

Transfer Pricing & Authority for Advance Rulings

Transfer pricing in taxation refers to the rules and methods for pricing transactions between enterprises under common ownership or control. These transactions could involve the trade of goods, services, or intangible assets.

The primary goal of transfer pricing rules is to ensure that the transactions between related parties are conducted at arm's length – that is, as if the transactions were between unrelated parties.

Key Aspects of Transfer Pricing

1. **Arm's Length Principle:** Transactions should be priced as if they were between unrelated parties. This is the cornerstone of transfer pricing rules.
2. **Intercompany Transactions:** Transfer pricing applies to cross-border and, in some jurisdictions, domestic transactions between related entities.
3. **Tax Compliance and Avoidance:** Transfer pricing is crucial for tax compliance. It prevents profit shifting and tax avoidance by multinational companies through manipulation of intercompany pricing.
4. **Pricing Methods:** Various methods are used to determine the appropriate transfer price, such as Comparable Uncontrolled Price (CUP), Resale Price Method, Cost Plus Method, Transactional Net Margin Method (TNMM), and Profit Split Method.

Transfer Pricing in India

Regulatory Framework: India has a comprehensive transfer pricing regulation under the Income Tax Act, 1961.

Reporting Requirements: Indian entities engaged in international transactions with associated enterprises must report these transactions and maintain specified documents.

Penalties: Non-compliance with transfer pricing rules can lead to hefty penalties and adjustments by tax authorities.

General Anti-Avoidance Rules (GAAR)

These are regulatory measures enacted by governments to counter aggressive tax planning strategies that exploit the loopholes in tax laws to avoid taxes. While tax avoidance is

legal, GAAR is designed to curb arrangements that, while legal, are primarily aimed at obtaining a tax benefit in a way that is not intended by the law.

Purpose: The primary purpose of GAAR is to prevent taxpayers from taking advantage of tax laws to artificially reduce their tax liability. It targets transactions or arrangements that are legal but are undertaken mainly for the purpose of avoiding tax.

Key Features of GAAR

1. **Substantive application:** GAAR generally applies to transactions that are considered to lack commercial substance or economic rationale other than achieving a tax benefit.
2. **Discretion to Tax Authorities:** GAAR gives broad powers to tax authorities to scrutinize and re-characterize transactions that are perceived as tax-avoidance schemes.
3. **Substance Over Form Principle:** GAAR emphasizes the substance of transactions over their legal form. If a transaction is carried out in a certain way primarily to gain a tax advantage, and not for a genuine commercial purpose, it can be re-characterized under GAAR.
4. **Penalties and Consequences:** GAAR can result in the denial of tax benefits and the imposition of penalties and interest.

GAAR in India

Implementation: GAAR was implemented in India from April 1, 2017, as part of the Income Tax Act, 1961.

Threshold Limit: GAAR provisions are applicable only to arrangements where the tax benefit exceeds a certain monetary threshold.

Guidelines for Administration: The Indian government has provided guidelines to ensure that GAAR is implemented in a uniform, fair, and rational manner.

Various Committees and Task Force Constituted For Direct and Indirect Tax Reforms in India

Committee and Task Force on Direct Tax Reforms Recommendations

S. No.	Committee/Task Force	Recommendations
1.	**Kelkar Committee (2002)** **Terms of Reference:** To review and recommend reforms in the direct tax system in India. **Objectives:** Simplify tax laws, rationalize tax rates, broaden the tax base, and enhance voluntary compliance.	1. Simplify tax laws to reduce complexity and improve compliance. 2. Rationalize tax rates by reducing the number of tax slabs. 3. Broaden the tax base by including more individuals and entities within the tax net. 4. Phasing out tax exemptions and deductions to eliminate tax avoidance loopholes. 5. Encourage voluntary compliance through taxpayer education and awareness programs. 6. Gradual reduction of corporate tax rates to make Indian industry more competitive globally.
2.	**Parthasarathi Shome Committee (2012):** **Terms of Reference:** To review the proposed General Anti-Avoidance Rules (GAAR) in the Finance Act, 2012. **Objectives:** Provide recommendations to bring clarity and balance to the GAAR provisions.	1. Suggested safeguards to prevent the misuse of GAAR provisions. 2. Recommended clear and objective criteria for determining tax avoidance. 3. Proposed a time limit for invoking GAAR provisions to provide certainty to taxpayers. 4. Advocated for a panel of experts to review GAAR cases to ensure fairness. 5. Proposed that GAAR should not be invoked in cases where tax treaties exist. 6. Recommended aligning GAAR provisions with international best practices to attract foreign investment.
3.	**Direct Tax Code (DTC) Committee (2009):** **Terms of Reference:** To draft a new direct tax code for India. **Objectives:** Simplify and modernize the direct tax system, revise tax slabs, deductions, exemptions, and improve tax administration.	1. Simplified tax structure with fewer tax slabs and deductions. 2. Introduction of a single code governing direct taxes to reduce complexity. 3. Phasing out various exemptions and deductions to broaden the tax base. 4. Lowering corporate tax rates to make India more attractive for investments. 5. Measures to reduce tax evasion and improve tax administration, including enhanced use of technology. 6. Simplified procedures for filing tax returns and assessments.

Committee and Task Force on Indirect Tax Reforms Recommendations

S. No.	Committee/Task Force	Recommendations
1.	**Raja J. Chelliah Committee (1991):** Terms of Reference: To recommend comprehensive reforms in the indirect tax structure in India. **Objectives:** Introduce a Value Added Tax (VAT) system and harmonize state and central taxes to reduce tax cascading.	1. Introduction of VAT System 2. Harmonization of State and Central Taxes 3. Uniform Rate Structure 4. Input Tax Credit 5. Exemption of Essential Goods 6. Standardization of Tax Administration 7. Taxpayer Education and Training
2.	**Kalyani Menon Sen Committee (2002):** **Terms of Reference:** To examine and recommend measures to simplify customs and excise procedures. **Objectives:** Streamline customs and excise processes to facilitate trade and reduce compliance burdens.	1. Simplification of Procedures 2. Electronic Filing and Payment 3. Transparency and Accountability 4. Trade Facilitation 5. Reduction of Litigation 6. Stakeholder Consultation 7. Simplification of Tariffs 8. Single Window Clearance
3.	**T. R. Rustagi Committee (2011):** **Terms of Reference:** To simplify and streamline the service tax structure and administration. **Objectives:** Simplify service tax procedures and suggest measures to make compliance easier for service providers.	1. Simplification of Tax Structure 2. Rationalization of Taxable Services 3. Electronic Filing and 4. Input Tax Credit (ITC) 5. Place of Provision of Services Rules 6. Regular Audits and Compliance Reviews
4.	**Arvind Subramanian Committee (2015)** **Terms of Reference:** To recommend a revenue-neutral rate (RNR) for GST. **Objectives:** Determine an RNR to ensure that the introduction of GST does not lead to substantial revenue loss for the government	1. Range for Revenue-Neutral Rate (RINR) 2. Lower Rate for Precious Metals 3. Additional 1% Inter-State Tax 4. Compensation Mechanism for States 5. Regular Review of Rates
5.	**GST Council (2016)** **Terms of Reference:** The council was formed to implement and administer the Goods and Services Tax (GST) in India. **Objectives:** Its objectives include setting tax rates for goods and services, recommending changes in tax rates, exemptions, and addressing any issues related to GST administration.	1. Determined tax rates for goods and services under the GST regime 2. Recommended revisions to tax rates based on economic conditions and revenue needs.

The Global Minimum Corporate Tax (GMCT) has emerged as a response to the practice of big technology companies shifting their profits to countries with lower corporate tax rates, often without relocating their actual business operations.

GMCT applies primarily to companies that have relocated their business to tax havens with lower tax rates. For companies based in such tax-friendly jurisdictions like Mauritius, they would continue to pay the lower tax rate of 5%.

The Global Minimum Corporate Tax Framework comprises two main pillars:

Once the Global Minimum Corporate Tax comes into effect, countries like India may need to reconsider measures such as the Equalization Levy, which they previously imposed on multinational technology companies like Google and Facebook.

G20-OECD "TWO" PILLAR SOLUTION FOR GLOBAL MINIMUM TAX

The G20-OECD "Two Pillar" solution is a significant global initiative aimed at addressing the tax challenges arising from the digitalization of the economy and the globalization of business models. This initiative, developed by the OECD and endorsed by the G20, aims to ensure that multinational enterprises pay a fair share of tax wherever they operate. The two pillars focus on different aspects of international taxation:

Pillar One: Reallocation of Profits

Objective: Pillar One aims to reallocate some taxing rights over multinational enterprises from their home countries to the markets where they have business activities and earn profits, regardless of whether firms have a physical presence there.

Scope: It targets the largest and most profitable multinational enterprises, potentially including digital giants like tech companies.

Mechanism: This involves creating new rules for taxing rights, which are more aligned with where value is created and where earnings are generated.

Revenue Source: The focus is on reallocating a portion of residual profit (above a certain threshold) to market jurisdictions.

Pillar Two: Global Minimum Tax

Objective: Pillar Two seeks to introduce a global minimum corporate tax rate. This is to prevent a "race to the bottom" where countries competitively lower their tax rates to attract multinational companies.

Minimum Tax Rate: The proposal is to establish a global minimum corporate tax rate of at least 15%.

Scope: This pillar is aimed at ensuring that multinational corporations pay a minimum level of tax on their income, regardless of where they are headquartered or where their income is earned.

Implementation: It involves the development of rules to ensure that multinational enterprises pay a minimum level of tax, including a set of interlocking rules to stop profit shifting to low-tax jurisdictions.

Current Status

As of April 2023, over 130 countries have agreed to the framework set out by the OECD for these reforms. However, the implementation details are complex and require significant coordination and agreement among various countries.

The "Two Pillar" solution represents a substantial shift in international tax rules and aims to address the challenges of a globalized, digital economy. It reflects a growing consensus that the international tax system needs to be reformed to ensure fairness and equity in the distribution of taxing rights among countries.

IGNITE YOUR MIND

Do you think the G20-OECD "Two Pillar" solution strikes an appropriate balance between addressing the challenges of the digitalized economy and ensuring fair taxation? How might it impact the competitiveness of different countries, and what considerations should be taken into account to avoid unintended consequences, particularly for smaller economies?

TAX BUOYANCY

Tax buoyancy is an important concept in fiscal policy, referring to the responsiveness of tax revenue growth to changes in the gross domestic product (GDP) or national income. It's a measure of how efficiently a tax system responds to economic growth or contraction.

Definition: Tax buoyancy is defined as the ratio of the percentage change in tax revenue to the percentage change in GDP. It indicates how tax revenues increase or decrease in response to changes in economic activity.

Formula: Tax Buoyancy = (Percentage change in tax revenue)/(Percentage change in GDP)

Interpretation

Buoyancy > 1	Tax revenues are growing at a faster rate than the economy. This usually occurs when the tax base expands due to either economic growth or effective tax administration and compliance.
Buoyancy < 1	Tax revenues are growing at a slower rate than the economy. This could be due to tax evasion, reductions in tax rates, or a shrinking tax base.
Buoyancy = 1	Tax revenues are growing at the same rate as the economy.

Tax Buoyancy in India

- **Economic Indicators:** In the Indian context, tax buoyancy is a critical indicator of fiscal health and the effectiveness of tax policy and administration.
- **Recent Trends:** The buoyancy of tax revenues in India varies, influenced by factors like changes in tax laws (like the introduction of GST), economic cycles, and administrative efforts to enhance compliance.

Non-Tax Revenue

Definition: Non-Tax Revenue is the recurring income earned by the government from sources other than taxes.

This Type of Revenue is an Important Part of a Government's Overall Income and Includes a Variety of Sources, Such as

- **Fees and Charges:** Revenue earned from providing services or issuing licenses and permits. This includes fees for government services like passport issuance, driving licenses, court services, and administrative services.
- **Fines and Penalties:** Money collected from penalties imposed for violations of laws and regulations. Examples include traffic fines, environmental violation penalties, and other legal penalties.
- **Profits from Public Enterprises:** Earnings from businesses owned or operated by the government. These can include profits from public utilities, transport companies, and other state-owned enterprises.
- **Interest and Dividends:** Income generated from investments held by the government, such as interest from bank deposits or dividends from shares in companies.
- **Royalties and Licenses:** Payments received for the use of government resources or property. This often includes royalties from natural resource extraction (like oil, gas, and minerals) and fees for broadcasting and telecommunication licenses.
- **Grants and Donations:** Funds received from other governments, international organizations, or private entities, as well as donations from individuals and organizations.
- **Sales of Goods and Services:** Income from the sale of various goods and services by government agencies.
- **Property Income:** Revenue from the rent, lease, or sale of government-owned property and assets.

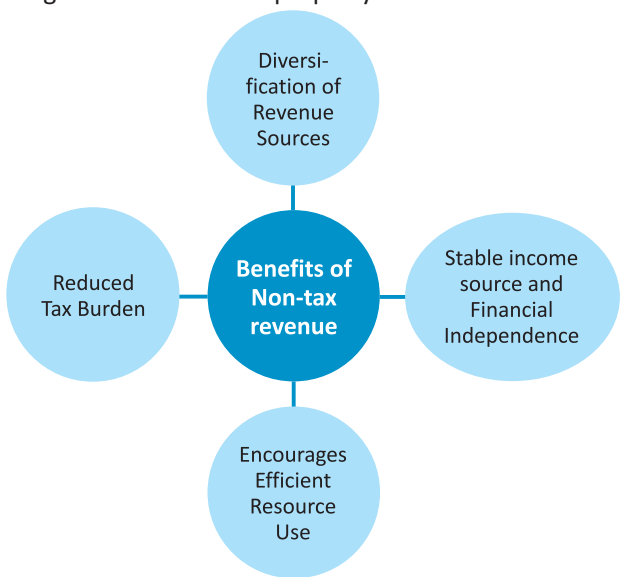


Fig. 9.16

Difference Between Tax Revenue and Non-Tax Revenue

Criteria	Tax Revenue	Non-Tax Revenue
Definition	Income earned by the government through imposing taxes on income, property, sales, and other activities.	Income earned by the government from sources other than taxes, such as fees, fines, and earnings from government-owned entities.
Nature	Compulsory citizens and businesses are legally required to pay taxes.	Generally voluntary, except for fines and penalties, and depends on the use of specific services or resources.
Flexibility	Less flexible; changes in tax rates or structures often require legislative approval and are politically sensitive.	More flexible; fees and charges can often be adjusted more easily than tax rates.
Purpose	Primarily to raise revenue for general government spending and redistribution of wealth.	Often tied to specific services or benefits; for example, a road toll for road maintenance.
Predictability	Relatively predictable and stable, forming a consistent part of government budgeting.	Can be less predictable, as it often depends on specific activities, market conditions, or user demand.
Impact on Behavior	Can influence economic behavior (like spending, investment) and has broader economic implications.	Often aimed at recovering costs, managing resources, or discouraging undesirable behavior (like fines).
Perception	Often seen as a mandatory burden by taxpayers.	Generally viewed as payment for specific services or as penalties for specific actions.

Non Tax Sources of Revenue of State Government

The state governments of the various states receive non-tax money from the sources listed below. State governments, like the **federal** government, offer a range of services, including:

Sale of stationery, Home guards, Jobs through state public services boards, Electricity, Gazettes, Municipal services, Police services, Administrative services

Total Receipts	The Government of India received ₹24,55,706 crore, which is 101% of the corresponding Revised Estimate (RE) for 2022-23
Tax Revenue (Net to Centre)	₹ 20,97,368 crore was collected in tax revenue.
Non-Tax Revenue	The non-tax revenue amounted to ₹ 2,86,151 crore.

Capital Receipts

Capital receipts refer to the **non-recurring** income sources of a government or an organization, typically acquired through **one-time transactions**. Unlike revenue receipts, which are regular and recurring, capital receipts are not a part of the normal business operations or governmental tax income. They are used to finance capital expenditures and are generally associated with the acquisition or maintenance of long-term assets. Here are some key aspects of capital receipts:

1. **Sale of Assets:** Income from the sale of long-term assets, like property, plant, equipment, or investments. In the case of a government, it may include the sale of public sector enterprises.
2. **Loans and Borrowings:** Funds received through loans or borrowings, either from domestic or foreign sources. For a government, this includes market loans, treasury bills, and external loans.
3. **Recovery of Loans:** Money received from the repayment of loans extended by the government to states, Union Territories, or other parties.
4. **Grants and Donations:** Large grants or donations received, which are not expected to recur regularly. This is more common in the context of non-profit organizations or government in case of international aid.
5. **Miscellaneous Capital Receipts:** Any other non-recurring receipts which don't fit into the regular revenue category, like proceeds from disinvestments.

Capital receipts are crucial for the financial planning and management of an organization or government, as they significantly impact its capital structure and financial stability. For governments, these receipts are important for funding infrastructure projects, repaying debts, or other capital investments, and are typically accounted for separately from the regular revenue streams.

Criteria	Revenue Receipts	Capital Receipts
Definition	Regular and recurring income of a government or organization, primarily from its core business activities.	Non-recurring income sources, often obtained from one-time transactions or financial events.
Nature	Regular and ongoing.	Usually one-time or non-recurring.
Examples	Taxes (income tax, sales tax), service fees, fines, interest income.	Sale of fixed assets, loans received, recovery of loans, disinvestment.
Purpose	Used for financing day-to-day operations and routine expenses.	Used to finance capital expenditures and investments or to pay off debts.
Impact on Assets or Liabilities	Typically do not result in the creation or reduction of assets or liabilities.	Often result in the creation of a liability (like a loan) or reduction in assets (like selling property).
Repayment Obligation	No repayment obligation as they are earned through regular operations.	May involve repayment obligations, especially in case of borrowings.
Sustainability	Sustainable and expected to continue over the long term.	Not sustainable as a long-term source of finance due to their non-recurring nature.
Accounting Treatment	Recorded as income in the profit and loss statement or budget.	Recorded on the balance sheet, reflecting a change in the financial position.

DISINVESTMENT IN PSU

The disinvestment process involves the sale of government stake in public sector enterprises to strategic or financial buyers, either through the sale of shares on stock exchanges or through the sale of shares directly to buyers.

The proceeds from the disinvestment are used to finance various social and infrastructure projects and to reduce the government's fiscal deficit.

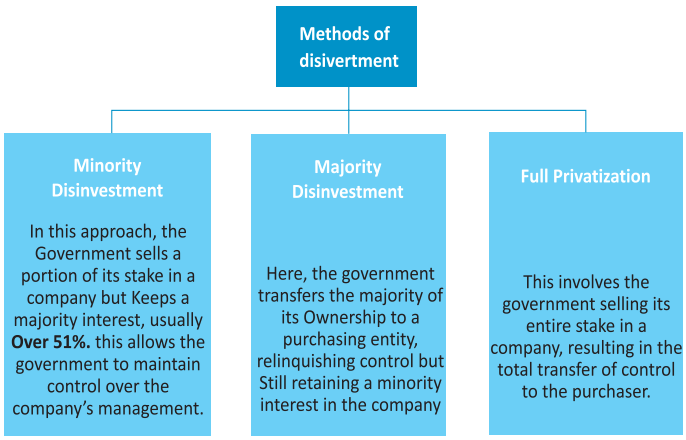

Methods of disivertment
Minority Disinvestment
In this approach, the Government sells a portion of its stake in a company but Keeps a majority interest, usually Over 51%. this allows the government to maintain control over the company's management.
Majority Disinvestment
Here, the government transfers the majority of its Ownership to a purchasing entity, relinquishing control but Still retaining a minority interest in the company
Full Privatization
This involves the government selling its entire stake in a company, resulting in the total transfer of control to the purchaser.

Fig. 9.17

Procedure of Disinvestment

- The disinvestment process in India is managed by the **Department of Investment and Public Asset Management (DIPAM), a department within the Ministry of Finance.**
- DIPAM's main goal is to oversee and handle the government's investments in public sector enterprises, including the process of disinvesting government shares in these entities.
- In **2005**, the Indian Government established the **National Investment Fund (NIF)**. The funds obtained from the disinvestment of **Central Public Sector Enterprises are directed into this fund.**

Need of Disinvestment in India

S. No.	Reason	Explanation
1.	Mitigating Fiscal Stress	Lessen fiscal burdens or to address revenue gaps within a particular fiscal year.
2.	Financing and Debt Retirement	The proceeds from disinvestment are utilized to fund fiscal deficits, invest in economic, social sector programs, or to pay off existing government debts.
3.	Promoting Private Ownership	Disinvestment fosters private sector participation in asset ownership and encourages open market trading.
4.	Stimulating Private Sector Investment	It signals the government's dedication to reform and the creation of a business-friendly environment, thereby attracting private investments.
5.	Reducing Government Liability	Successful disinvestment means the government no longer needs to subsidize loss-incurring entities.
6.	Enhancing Operational Efficiency	Privatization of public enterprises can boost their efficiency and market competitiveness, as private ownership often introduces innovative management and market-driven strategies.
7.	Resource Reallocation	Resources obtained from disinvestment can be redirected to other critical areas like social welfare and infrastructure projects.
8.	Increasing Accountability	The process of disinvestment can lead to improved transparency and responsibility in the management of public enterprises, driven by the more rigorous financial and operational standards of the private sector.

Disinvestment Strategy For 2023-24

1. **No New Additions to CPSEs List:** The decision to refrain from adding new CPSEs to the disinvestment list for 2023-24.
2. **Focus on Announced Privatizations:** Emphasis on proceeding with the privatization of already declared state-owned companies.
3. **Specific Companies Targeted:** Inclusion of specific entities such as IDBI Bank, Shipping Corporation of India, Container Corporation of India Ltd, NMDC Steel Ltd, BEML, and HLL Lifecare in the disinvestment plan.
4. **Pending Disinvestments from 2019:** The ongoing status of the disinvestment processes for Bharat Petroleum Corporation Limited, Shipping Corporation of India, and Container Corporation of India, initially approved in 2019.

Challenges of Disinvestment in India

1. **Political Resistance**

   Example: Protests and opposition from political parties and trade unions against the proposed sale of Air India, citing concerns about employee welfare and national interest.

2. **Challenges in Valuing Enterprises:**

   Example: Difficulty in valuing Bharat Petroleum Corporation Limited (BPCL) due to fluctuating oil prices and its strategic importance in the energy sector.

3. **Workforce Concerns:**

   Example: Employee apprehensions and protests regarding job security and benefits at the time of disinvestment of Hindustan Zinc Limited.

4. **Limited Buyer Interest:**

   Example: The government's struggle to find buyers for Air India initially, partly due to its high debt and operational inefficiencies.

5. **Regulatory Hurdles:**

   Example: The lengthy approval process and regulatory compliance required for the disinvestment of Bharat Petroleum Corporation Limited (BPCL), involving environmental, labor, and market regulations.

6. **Legal Obstacles:**

   Example: Legal challenges faced during the disinvestment of Hindustan Petroleum Corporation Limited (HPCL), where the Supreme Court was approached to examine the legitimacy of the disinvestment process.

PUBLIC EXPENDITURE

Public expenditure is expenditure by the government on various government activities and social sector services. Public expenditure is necessary for supporting the economy and economic activities.

The purpose of public expenditure is not limited to providing essential goods and services but also it provides employment and liberal rights to use to its population.

Classification of The Public Expenditure

- **Development and Non-Development Expenditure:**
  - **(a) Development Expenditure:** Includes productive government spending that promotes social welfare and economic growth. This includes investment in capital goods and services, economic services, and social services.
  - **(b) Non-Development Expenditure:** Constitutes consumption expenditure like subsidies, defense, salaries, and pensions. These offer immediate societal benefits but don't contribute to economic growth.
- **Plan and Non-Plan Expenditure (Post 1987-88 as per Sukhomoy Chakravarti Committee):**
  - **(a) Plan Expenditure:** Comprises all expenditures included in the central plan. These are productive and related to asset creation.
  - **(b) Non-Plan Expenditure:** Covers expenses on completed schemes, interest payments on borrowings, and generally includes non-asset building and consumption expenditures.
- **Capital and Revenue Expenditure (Redefinition Suggested by Dr. C Rangarajan in 2011):**
  - **(a) Capital Expenditure:** Non-recurring expenses on building fixed assets, aimed at enhancing economic and social productivity. Includes loans to states and foreign governments, and capital defense expenditure.
  - **(b) Revenue Expenditure:** Recurring expenses incurred annually for current consumption. These include salaries, pensions, and subsidies.

Principles of Public Expenditure

1. **Efficiency:** Ensuring that expenditure leads to the best possible outcomes with the least possible resource use.
2. **Equity:** Fair distribution of resources, focusing on the needs of disadvantaged and marginalized groups.
3. **Transparency and Accountability:** Clear and open processes for budget formulation, approval, and implementation, with mechanisms for accountability.
4. **Economy:** Minimizing costs and avoiding wastage in government spending.
5. **Priority to Developmental Expenditure:** Prioritizing spending on sectors that drive economic growth and development.
6. **Sustainable Debt and Fiscal Prudence:** Maintaining sustainable levels of debt and fiscal discipline to ensure long-term economic stability.
7. **Responsiveness and Flexibility:** Ability to adapt expenditure priorities in response to changing economic and social conditions.
8. **Maximizing Social Benefit:** Ensuring that public spending yields the greatest social benefits, particularly in terms of poverty reduction and improving living standards.

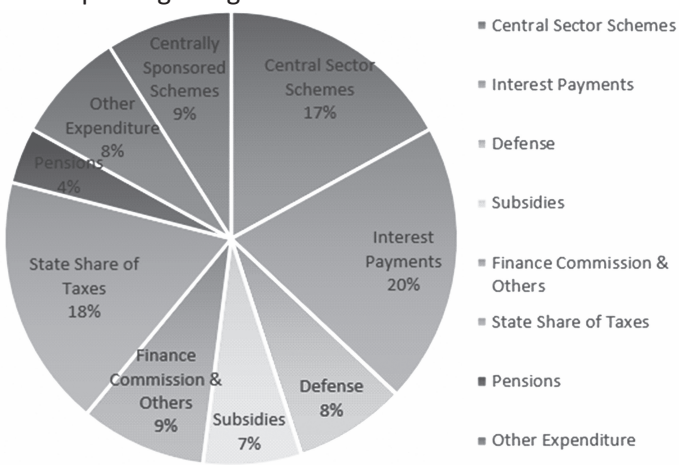


Fig. 9.18: Government's Spending in FY24

Problems of Public Expenditure in India

The problems of public expenditure in India are multifaceted and arise from various structural, administrative, and policy-related issues. Here are some key challenges:

1. **Inefficient Allocation of Resources:** Public funds are not always allocated optimally, leading to wasteful expenditure in some areas while underfunding critical sectors like health and education.

2. **Subsidy Burden:** Large-scale subsidies, though intended for welfare, often strain the fiscal budget and may not always reach the intended beneficiaries due to inefficiencies in the distribution system.
3. **Fiscal Deficit and Debt Management:** High public expenditure contributes to fiscal deficits and increasing public debt, which can lead to long-term macroeconomic instability.
4. **Corruption and Leakages:** Corruption at various levels of government administration results in leakages of funds, reducing the effectiveness of public spending.
5. **Lack of Outcome Orientation:** There's often a focus on the input and output rather than the outcome, leading to inefficiency in achieving the intended social and economic objectives.
6. **Ineffective Monitoring and Evaluation:** The absence of robust mechanisms for monitoring and evaluating public expenditure programs often leads to inefficiency and ineffectiveness in the utilization of funds.
7. **Regional Disparities:** Public expenditure often does not adequately address regional disparities, leading to uneven development across different parts of the country.
8. **Political Influence and Populism:** Spending decisions are sometimes more influenced by political considerations rather than economic rationale, leading to populist spending which may not be sustainable in the long run.
9. **Bureaucratic Delays and Red Tape:** Excessive bureaucracy and procedural delays can hinder the timely and effective use of public funds.
10. **Rigid Budgetary Frameworks:** The inflexibility in budgetary allocations does not allow for dynamic reallocation of resources based on changing needs and priorities.

Public expenditure reforms suggested by various committee in India

Committee	Year	Key Recommendations
L.K. Jha Committee	1976	1. Commission was constituted on matter of Indirect Tax reforms
Raja Chelliah Committee on Tax Reforms	1991	1. Rationalization of government subsidies. 2. Enhance direct tax collections. 3. Shift from non-merit to merit subsidies.
Fifth Pay Commission	1997	1. Reduce non-plan government expenditure. 2. Increase efficiency of government employees. 3. Downsize and rightsize workforce in government sectors.
Expenditure Management Commission	2014	1. Comprehensive review and overhaul of government subsidies. 2. Better targeting and delivery of subsidies through direct benefit transfers.
14th Finance Commission	2013	1. Increase states' share in central taxes to promote fiscal federalism. 2. Provide greater autonomy to states in fiscal spending.
N.K. Singh Committee on FRBM	2017	1. Establish a clear fiscal roadmap for central and state governments. 2. Use fiscal deficit as the primary target for fiscal consolidation.
Economic Advisory Council to the Prime Minister (EAC-PM)	Recent Years	1. Rationalize government spending and enhance its quality. 2. Use technology and innovation to improve public expenditure effectiveness.

GOVERNMENT DEFICITS

A government deficit occurs when a government's expenditures exceed its revenues in a given period. In other words, it's the difference between what the government spends and what it collects in taxes and other sources. This deficit leads to government borrowing to cover the gap between spending and revenue. Various types of government deficits are:

Each of These are Discussed Below in Detail

1. **Revenue Deficits**
   - A revenue deficit occurs when a government's total revenue is insufficient to cover its current expenditure, excluding capital expenditures.

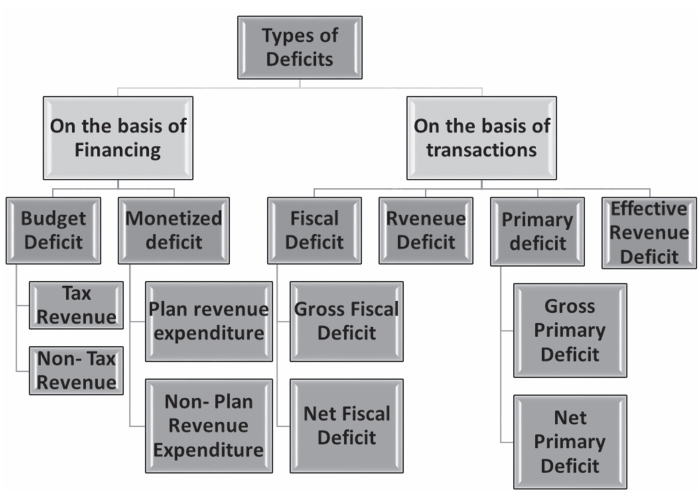


Fig. 9.19

- In simpler terms, it indicates that the government is not generating enough income to meet its day-to-day operational expenses, such as salaries, subsidies, and interest payments, without borrowing.

Revenue Deficit = Total Revenue Expenditure – Total Revenue Receipts

A. Components of Revenue Deficit:

(a) Revenue Receipts: These include income from taxes, non-tax revenue and grants from other governments or international organizations.

(b) Revenue Expenditure: This consists of the government's operational expenses, such as salaries, pensions, subsidies, interest payments, and other routine expenditures.

B. Implications of Revenue Deficit:

(a) A revenue deficit implies that the government is relying on borrowed funds to meet its day-to-day expenses, as opposed to using borrowed money for capital investments or development projects.

(b) It indicates a potential imbalance in the government's fiscal management, as a sustained revenue deficit may lead to a rising debt burden.

C. Borrowing to Cover Revenue Deficit:

(a) To cover a revenue deficit, a government may borrow through the issuance of bonds or other debt instruments. This borrowing adds to the overall public debt.

(b) While **borrowing for capital expenditures** may contribute to **economic development**, **borrowing to cover operational expenses** raises concerns about **fiscal sustainability.**

D. Fiscal Discipline:

(a) Governments may need to focus on **increasing revenue** through tax reforms, **improving tax collection efficiency**, and **controlling unnecessary expenditures** and **rationalizing subsidies** and **welfaristic programmes.**

E. Long-Term Impacts:

(a) Persistent revenue deficits can have long-term consequences on a country's economic health. It may lead to a **higher debt-to-GDP ratio**, **increased interest payments**, and **potentially crowd out funding** for essential development projects.

F. Policy Measures:

(a) These measures could include **increasing tax revenue**, **reducing non-essential expenditures**, **improving the efficiency of public spending**, and **promoting economic growth** to enhance overall revenue.

2. Fiscal Deficit:

- The fiscal deficit is a key indicator of a government's financial health and represents the difference between its total expenditures and total revenues, excluding money from borrowings.
- It's a measure of how much the government needs to borrow to meet its expenditures when its total spending exceeds the revenue it generates.

Fiscal Deficit = Total Expenditure – Total Revenue (excluding borrowings)

A. Key Components of the Fiscal Deficit:

(a) Total Expenditure: This includes **all government spending**, both on a **revenue account** (day-to-day expenses like salaries, subsidies, and interest payments) and **capital account** (long-term investments and expenditures).

(b) Total Revenue (excluding borrowings): This includes tax revenue, non-tax revenue, and grants. **Borrowings are excluded to focus on the underlying fiscal position.**

B. Implications of Fiscal Deficit:

(a) A **persistently high fiscal deficit** may lead to concerns about the government's **ability to service its debt** and may result in **higher interest rates**.

(b) It implies that the government **needs to borrow to meet its spending** requirements.

C. Fiscal Discipline:

(a) A fiscal deficit can be a deliberate policy choice during economic downturns to stimulate growth through increased government spending.

(b) Fiscal discipline involves managing the fiscal deficit to maintain a balance between growth stimulation and debt sustainability.

D. Relation to Government Debt:

(a) The fiscal deficit contributes to the accumulation of government debt. When a government runs a fiscal deficit, it typically borrows to cover the gap between spending and revenue.

E. Macroeconomic Implications:

(a) The fiscal deficit has broader implications for the economy, influencing factors such as interest rates, inflation, and overall economic stability.

Governments closely monitor their fiscal deficit as part of their fiscal policy management, aiming to strike a balance between promoting economic growth and maintaining fiscal sustainability. It's an important metric for assessing a government's fiscal responsibility and its impact on the overall economy.

3. Primary Deficit

The primary deficit is a key fiscal metric that measures the **difference between** a government's **total expenditures (excluding interest payments on existing debt**) and its **total revenue**.

Essentially, the primary deficit provides insight into the **government's fiscal position, excluding the impact of interest payments.**

Primary Deficit = Fiscal Deficit – Net Interest Payments on Debt

A. **Components of the Primary Deficit:**
   (a) **Fiscal Deficit:** This is the difference between a government's total expenditures and total revenue, including interest payments on existing debt.
   (b) **Interest Payments on Debt:** This component represents the amount the government **spends on servicing its existing debt.**

B. **Implications of the Primary Deficit:** It helps assess whether the government is **borrowing to cover ongoing operational expenses or to service existing debt.** This may raise concerns about the sustainability of fiscal policy.

C. **Debt Management:** A government with a primary deficit may find it **challenging to reduce its overall debt burden** because it is borrowing not only to cover interest payments but also to fund its operational activities.

D. **Relation to Fiscal Responsibility:** Managing and reducing the primary deficit is often a goal for governments aiming to demonstrate fiscal responsibility. **Controlling the primary deficit can contribute to a sustainable fiscal policy.**

While some level of borrowing may be necessary for productive investment and economic growth, an excessively high primary deficit may signal fiscal challenges and potential risks to long-term economic stability.

4. Effective Revenue Deficit

Effective revenue deficit excludes certain revenue expenditures that are considered productive or developmental in nature. The idea is to distinguish between regular revenue expenditures and those that contribute to capital formation or asset creation.

Effective Revenue Deficit = Revenue Deficit – Net Grants for Capital Creation

In India

Effective Revenue Deficit = Revenue Deficit – Grants given to states for Capital Creation

A. **Key components of Effective Revenue Deficit**
   (a) **Revenue Deficit:** It reflects the shortfall when current revenue receipts are **not sufficient to cover current revenue expenditures.**
   (b) **Grants for Capital Creation:** This component includes grants for **capital expenditure** or asset creation.

B. **Significance of Effective Revenue Deficit:** It provides a **more refined measure of the revenue deficit** by excluding certain expenditures that are considered developmental in nature.

C. **Focus on Capital Formation:** By excluding grants for capital creation, the effective revenue deficit aims to focus on revenue expenditures that do not contribute to capital formation, thereby providing a **clearer picture of the government's commitment to fiscal discipline.**

D. **Developmental Expenditures:** It acknowledges that **some revenue expenditures contribute to long-term development**, such as investments in **infrastructure, education, and healthcare**. These expenditures are **excluded** from the deficit to **encourage developmental activities.**

E. **Policy Implications:** Governments may use it to assess the **impact of their revenue expenditures on capital formation** and to align fiscal policy with developmental goals.

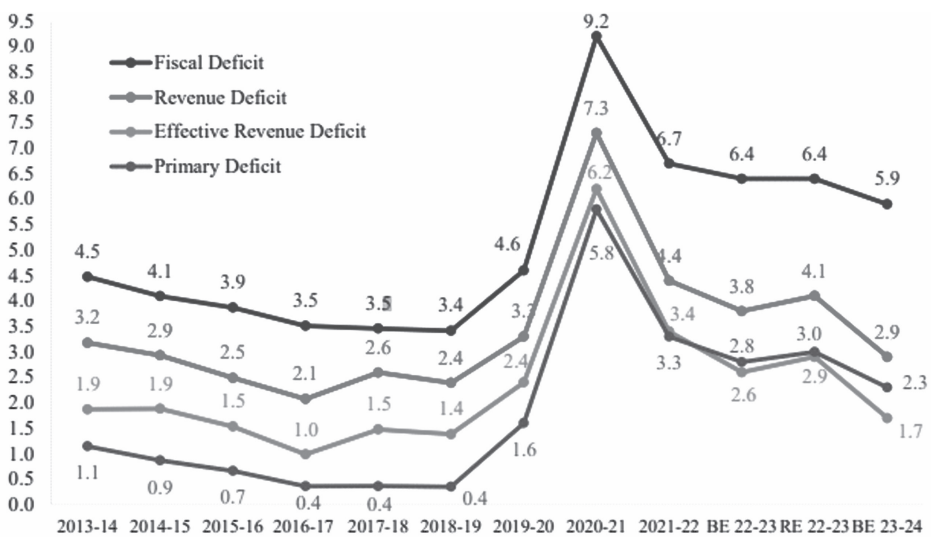


Fig. 9.20: Deficit Trends

It's important to note that the concept of effective revenue deficit is **not universally adopted**. Policymakers consider it **alongside other fiscal indicators** to gain a **comprehensive understanding of a government's fiscal position** and its commitment to both **short-term** stability and **long-term development.**

5. Effective Capital Expenditure

"Effective capital expenditure" is not a standardized or widely recognized term in economic or financial literature.

In India, The Central Government provides various grants to States and Union Territories, classified as revenue expenditure at the central level. However, certain grants result in the creation of assets owned by the State government, not the Central government. While categorized as revenue expenditure for the Central Government, these grants essentially contribute to the development of assets for the respective State governments.

Effective Capital Expenditure = Capital Expenditure + Grants given to states for creation of capital assets

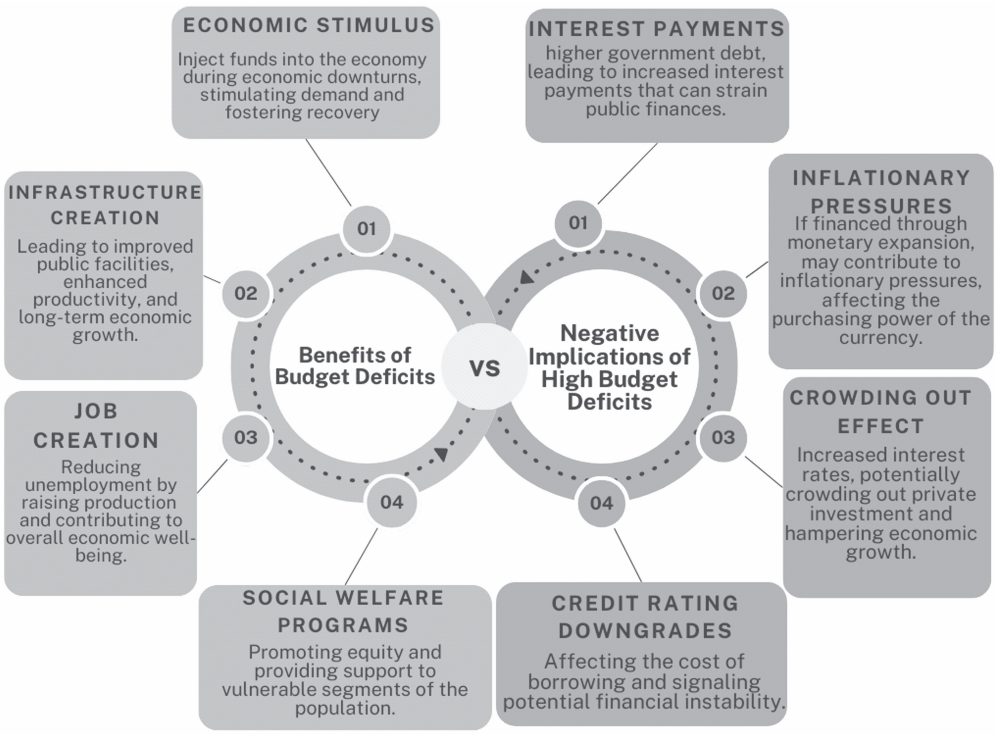

ECONOMIC STIMULUS
Inject funds into the economy during economic downturns, stimulating demand and fostering recovery
INTEREST PAYMENTS
higher government debt, leading to increased interest payments that can strain public finances.
INFRASTRUCTURE CREATION
Leading to improved public facilities, enhanced productivity, and long-term economic growth.
INFLATIONARY PRESSURES
If financed through monetary expansion, may contribute to inflationary pressures, affecting the purchasing power of the currency.
JOB CREATION
Reducing unemployment by raising production and contributing to overall economic well-being.
CROWDING OUT EFFECT
Increased interest rates, potentially crowding out private investment and hampering economic growth.
SOCIAL WELFARE PROGRAMS
Promoting equity and providing support to vulnerable segments of the population.
CREDIT RATING DOWNGRADES
Affecting the cost of borrowing and signaling potential financial instability.
Benefits of Budget Deficits
VS
Negative Implications of High Budget Deficits
01
02
03
04

Fig. 9.21: General Analysis of Budgetary Deficits

FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT (FRBM) ACT 2003

The Fiscal Responsibility and Budget Management (FRBM) Act of 2003 is an important piece of legislation in India aimed at institutionalizing fiscal discipline and prudence in the management of the country's finances. The Act was enacted by the Government of India with the objective of promoting long-term macroeconomic stability and reducing fiscal deficits to sustainable levels.

Documents Mandated by FRBM to be Put Along The Budget in Parliament

1. **Medium-tern Fiscal Policy Statement:** This document outlines the three-year rolling targets for specific fiscal indicators, It includes the government's **strategic priorities and the fiscal policies** it plans to use to achieve these targets.
2. **Fiscal Policy Strategy Statement:** This statement explains the strategic priorities of the government for the focal year. It includes the policies and rationale for any major deviation in fiscal measures or fiscal indicators and the likely impact of such policies on fiscal sustainability.
3. **Macroeconomic Framework Statement:** This statement provides an **assessment of the growth prospects of the economy,** with a detailed analysis supporting the budget estimates includes key macroeconomic forecasts and the underlying resumptions.
4. **Statement of Revenue foregone:** Although **not explicitly mentioned in the original FRBM Act,** this statement **became a regular feature of budget documents.** It details the **revenue impact of tax concessions** and incentives

5. **FRBM Act (Amendment), 2012:** Introduced the concept of **"Effective Revenue Deficit"** and mandated a statement on this as well. Effective Revenue Deficit excludes those revenue expenditures in the form of grants for the cation of capital assets.

These documents are designed to provide a comprehensive view of the government's fiscal strategic policy rationale, and the expected impact on the economy They play a crucial role in ensuring accountability and transparency in fiscal governance.

Objectives of FRBM Act, 2003

- **Reduce fiscal deficits** by limiting government spending and revenue gap.
- **Control government debt** by bringing it to a sustainable level.
- **Promote macroeconomic stability** by avoiding excessive government borrowing and inflation.
- **Ensure intergenerational equity** by distributing fiscal benefits and burdens fairly across generations.
- **Enhance transparency and accountability** by providing detailed information on fiscal performance and liabilities.
- **Medium-term fiscal policy planning** by presenting a statement of fiscal policies for the next three to five years.

Initial Targets of FRBM Act, 2003

Target Category	Initial FRBM Targets (to be met by 2008-09)
Revenue Deficit Target	Revenue deficit should be completely eliminated by March 31, 2009. The minimum annual reduction target was 0.5% of GDP.
Fiscal Deficit Target	Fiscal deficit should be reduced to 3% of GDP by March 31, 2009. The minimum annual reduction target was 0.3% of GDP.
Contingent Liabilities	The Central Government shall not give incremental guarantees aggregating an amount exceeding 0.5% of GDP in any financial year beginning 2004-05.
Additional Liabilities	Additional liabilities (including external debt at current exchange rate) should be reduced to 9% of the GDP by 2004-05. The minimum annual reduction target in each subsequent year to be 1% of GDP.
RBI Purchase of Government Bonds	RBI purchase of government bonds ceased from April 1, 2006. This indicates the government's commitment not to borrow directly from the RBI.

Above Objectives were to be Met By Below Three Approach

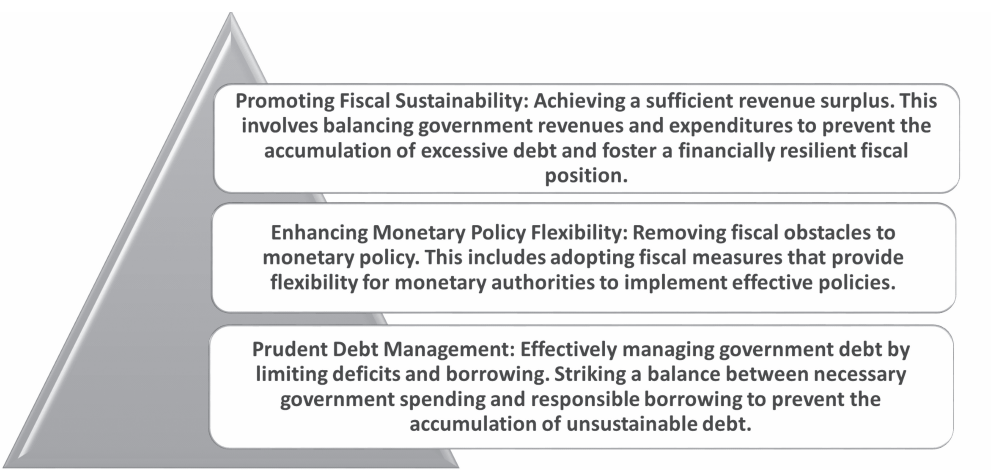

Promoting Fiscal Sustainability: Achieving a sufficient revenue surplus. This involves balancing government revenues and expenditures to prevent the accumulation of excessive debt and foster a financially resilient fiscal position.
Enhancing Monetary Policy Flexibility: Removing fiscal obstacles to monetary policy. This includes adopting fiscal measures that provide flexibility for monetary authorities to implement effective policies.
Prudent Debt Management: Effectively managing government debt by limiting deficits and borrowing. Striking a balance between necessary government spending and responsible borrowing to prevent the accumulation of unsustainable debt.

Fig. 9.22: 3-Pronged approach for achieving FRBM, 2003 targets

Some of The Important Features of FRBM Act, 2003 are as

- **Fiscal Targets for Union Government:**
  - The union government is mandated to take measures to limit the fiscal deficit to 3% of GDP by March 31, 2021.
  - The government aims to ensure that the general government debt (central government debt plus state government debt) does not surpass 60% of GDP by 2024-25, and the union government debt remains below 40% of GDP by the same period.
  - Additional guarantees for loans secured against the Consolidated Fund of India should not exceed 0.5% of GDP in any financial year.

- The union government is committed to avoiding the exceeding of fiscal targets after the specified target dates.

- **Annual Targets for Fiscal Deficit Reduction:** The union government is responsible for prescribing annual targets for the reduction of fiscal deficit in case it exceeds the specified limit. Exceptions to annual fiscal deficit targets may be allowed based on conditions such as national security, acts of war, national calamities, and others (escape clause).
- **Limit on Deviation from Fiscal Deficit Target:** Any deviation from the fiscal deficit target under the escape clause shall not exceed 0.5% of GDP in a year.
- **Responsiveness to Real Output Growth:** In the event of a significant increase in real output growth, the union government is required to reduce the fiscal deficit by at least 0.25% of GDP in a year.
- **Restrictions on RBI Borrowing:** The central government is prohibited from borrowing from the RBI, except for advances to meet temporary excesses of cash disbursements over cash receipts. However, exceptions are allowed under the escape clause.
- **RBI's Role in Primary and Secondary Markets:** Despite restrictions, the RBI may subscribe to primary issues of central government securities and engage in buying and selling central government securities in the secondary market under specified conditions.
- **Fiscal Transparency Measures:** The union government is obligated to ensure greater transparency in fiscal operations and minimize secrecy in budget preparation. During budget presentations, the government must make prescribed disclosures in a transparent manner.
- **Half-Year Review by the Finance Minister:** The finance minister is required to review trends in receipts and expenditure on a half-yearly basis and present the outcomes before both Houses of Parliament.
- **Parliamentary Approval for Deviations:** Except as provided under the Act, no deviation from meeting the obligations under this Act is permissible without the approval of Parliament.
- **CAG Review:** The union Government may assign the Comptroller and Auditor General (CAG) of India to periodically review compliance with the provisions of this Act, with the results laid before both Houses of Parliament.
- **Annual Statements of Fiscal Policy:** The union government must lay before both houses of Parliament statements of fiscal policy, including the Macro-economic Framework Statement, Medium Term Fiscal Policy Statement and Fiscal Policy Strategy Statement. In the session following the budget presentation.
- **State-Level Fiscal Limits:** Similarly, every state has established a fiscal deficit limit of 3% in their laws.

Despite the challenges posed by the unprecedented Covid-19 crisis, there have been deviations from Fiscal Deficit and Debt parameters from the target levels. The government, however, has not proposed an amendment to the FRBM Act, stating that retaining fiscal flexibility is crucial for effectively responding to emerging contingencies until uncertainties from the pandemic ease. The government aims to pursue a path of fiscal consolidation to achieve a fiscal deficit lower than 4.5% of GDP by FY 2025-26.

Subsequent FRBM Amendments

The Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2003 with the intention to set targets for the government to reduce fiscal deficits.

Recent Amendments to The FRBM Act

1. In the Medium Term Fiscal Policy Statements for 2021-22 and 2022-23, rolling targets for budget deficits were not presented.
2. The 2022 Budget proposes reducing the fiscal deficit to under 4.5% of GDP by the fiscal year 2025-26.
3. The projected fiscal deficit for 2022-23 is 6.4% of GDP, reflecting the government's borrowing to finance its expenditures.
4. The anticipated revenue deficit for 2022-23 stands at 3.8% of GDP, indicating the government's need to borrow for expenses that are unlikely to yield future returns.
5. Revised estimates suggest a slight increase in the fiscal deficit to 6.9%, exceeding the budget estimate, while the revenue deficit is expected to reduce to 4.7%.
6. The target for the primary deficit (the fiscal deficit excluding interest payments) is set at 2.8% of GDP for 2022-23.
7. Interest payments as a percentage of revenue receipts have risen from 36% in 2011-12 to 42% in 2020-21.

IGNITE YOUR MIND

Do you think the escape clause provisions within the FRBM Act, allowing for deviations from fiscal targets under certain circumstances, weaken the overall effectiveness of the Act in promoting fiscal discipline? How can these provisions be balanced with the need for flexibility in responding to unforeseen emergencies?

Based on budget estimates, this percentage is projected to climb to 43% in 2022-23.

These updates indicate a continued focus on managing fiscal deficits while also acknowledging the challenges posed by increased borrowing and interest obligations.

FSLRC (Justice B N Srikrishna Committee, 2011)

The Financial Sector Legislative Reforms Commission (FSLRC) was a body constituted by the Government of India in March 2011, with the aim of reviewing and rewriting the legal-institutional architecture of the Indian financial sector. It was chaired by Justice B. N. Srikrishna, a former judge of the Supreme Court of India. The commission's mandate was broad and comprehensive, covering all laws and regulations affecting the financial sector in India.

Key Objectives and Goals

1. **Consolidation and Harmonization:** The FSLRC aimed to simplify and harmonize the financial sector legislation, which was fragmented across various laws and regulations.
2. **Modernization of Financial Laws:** The commission sought to modernize and update the financial laws to meet the changing requirements of the Indian economy and align with global practices.
3. **Reducing Ambiguities:** It aimed to reduce ambiguities and complexities in financial sector legislation, making the laws more coherent and accessible.
4. **Consumer Protection:** Enhancing the mechanisms for consumer protection in the financial sector was a key focus.
5. **Financial Stability:** The commission worked towards ensuring the stability and robustness of the financial system in India.
6. **Promoting Efficiency and Competition:** Another objective was to promote efficiency and competition in the financial markets.

Key Recommendations

1. **Unified Financial Authority:** The FSLRC recommended the establishment of a unified regulatory agency to oversee the entire financial sector, excluding banking and payments, which were proposed to be regulated by the Reserve Bank of India (RBI).
2. **Consumer Protection:** It emphasized a strong framework for consumer protection in the financial sector, suggesting the creation of a financial redressal agency.
3. **Financial Stability and Development Council:** The commission recommended strengthening the role of the Financial Stability and Development Council (FSDC) in maintaining financial stability.
4. **Monetary Policy Framework:** The FSLRC suggested a clear framework for the role of the RBI in monetary policy, financial stability, and regulation of banks and payment systems.
5. **Resolution Corporation:** The commission proposed setting up a Resolution Corporation for resolving distress in financial firms.
6. **Law Reforms:** It recommended the repeal of over 60 archaic financial laws and proposed a draft code to streamline the complex maze of financial sector regulations.

Impact and Implementation

- The recommendations of the FSLRC have had a significant impact on the financial sector in India. Some of its recommendations have been implemented, like the adoption of the Insolvency and Bankruptcy Code and amendments to the RBI Act for monetary policy committee formation.
- The idea of a unified financial authority, however, has seen a more cautious approach, with sectoral regulators like SEBI, IRDAI, and PFRDA continuing to function independently.
- The FSLRC's work represents a significant step towards creating a more efficient, consumer-friendly, and stable financial regulatory environment in India. Its recommendations continue to guide discussions and reforms in the Indian financial sector.

GOVERNMENT BORROWINGS

Objectives of Public Debt in India

S. No.	Objectives	Explanation
1.	Bridging Revenue Gaps	Public debt is primarily aimed at covering the shortfall arising from the mismatch between planned expenditure and expected revenue.
2.	Managing Emergencies	To address financial needs during emergencies like floods, famines, earthquakes, or pandemics, which lead to increased government spending.
3.	Alleviating Economic Depression	During economic downturns, public debt helps stimulate the economy by compensating for reduced investment and consumer spending.
4.	Controlling Inflation	Borrowing helps in absorbing excess purchasing power during inflationary periods, thus helping in stabilizing the economy.
5.	Funding Development Projects	In a developing economy, public debt is crucial for financing development plans, especially when relying on heavy taxation is not feasible.
6.	Improving Education and Health Services	Government borrows to invest in the development and expansion of essential public services like education and healthcare.
7.	Maintaining Public Support	Sometimes, to avoid unpopular tax increases, the government opts for borrowing, especially when tax enhancement is politically challenging.

Components of Government's Debt and Liabilities

- **Market Borrowings:**
  - This is the most significant portion of the government debt.
  - Includes government securities (G-Secs) such as treasury bills and dated securities issued through auctions.
- **Loans from Banks and Financial Institutions:**
  - Loans taken from domestic banks and financial institutions.
  - Often used for specific projects or bridging short-term funding gaps.
- **External Debt:**
  - Borrowings from foreign governments, international financial institutions, and through sovereign bonds issued to foreign investors.
  - Includes loans from the World Bank, Asian Development Bank, and bilateral credits.
- **Small Savings and Provident Funds:**
  - Funds accumulated through various small saving schemes like the Public Provident Fund (PPF), National Savings Certificate (NSC), and other saving instruments.
  - These savings are often used by the government for its expenditure needs.
- **State Development Loans (SDLs):**
  - Loans taken by state governments, but the central government may also bear a portion of this debt.
  - Issued through securities to fund various state-level projects.
- **Securities Against Small Savings:** Debt instruments issued against small savings collections.
- **Treasury Bills:**
  - Short-term debt instruments issued by the government to meet immediate financial needs.
  - Generally, they have a maturity period of less than one year.
- **Special Securities Issued to RBI:** Special bonds or securities issued to the Reserve Bank of India under specific circumstances.
- **Other Liabilities:** Includes various other forms of borrowings like oil bonds, fertiliser bonds, etc., which are typically issued for specific purposes.

Factors Contributing to Increased Public Debt in India

- **Bank Recapitalization Efforts:** The infusion of capital into state-owned banks via recapitalization bonds in 2017-18 significantly raised the central government's debt both in absolute terms and as a percentage of GDP.
- **Issuance of UDAY Bonds:** State liabilities escalated in 2015-16 and 2016-17 due to the issuance of Ujwal Discom Assurance Yojna (UDAY) bonds.
- **Low Tax-to-GDP Ratio:** Despite a fourfold increase in national income since independence, India's gross tax-to-GDP ratio stands at around 11.7% as of 2021. The majority of tax revenue is derived from indirect taxes.
- **Flaws in the Tax System:** The Indian tax system is plagued with inefficiencies, leading to high levels of tax evasion.
- **Inefficient Use of Public Funds:** Significant amounts of public funds are expended inefficiently in government departments, often marred by corruption, bribery, and bureaucratic red tape, leading to reduced productivity and wastage of resources.

These factors collectively contribute to the growing public debt in India, highlighting the need for fiscal reforms and efficient public finance management.

Public Debt Management and Associated Agencies in India

1. **Reserve Bank of India (RBI):**
   - The RBI plays a central role in the management of India's internal debt.
   - It is responsible for issuing government securities, managing the government's debt, and handling monetary policy, which influences interest rates and debt servicing costs.
2. **Ministry of Finance, Government of India:**
   - The Ministry of Finance is responsible for overall fiscal policy and debt strategy.
   - The Department of Economic Affairs within the Ministry oversees external borrowings, sovereign credit ratings, and liaises with international financial institutions.
3. **Securities and Exchange Board of India (SEBI):**
   - SEBI regulates the securities market in India, including the trading of government securities.
   - It ensures a transparent and efficient market for government bonds, impacting their attractiveness to investors.
4. **Public Debt Office (PDO):**
   - Operated under the RBI, the PDO is responsible for the issuance and servicing of government securities.
   - It maintains the records of government debt and ensures timely payment of interest and principal to investors.
5. **Fiscal Responsibility and Budget Management (FRBM) Review Committee:**
   - This committee reviews the government's fiscal discipline and adherence to budgetary targets, indirectly influencing public debt management strategies.

6. **Banks and Financial Institutions:**
   - Banks and financial institutions are major subscribers to government securities.
   - Their participation in government debt instruments is crucial for the success of debt auctions and overall debt management.

Establishment of Public Debt Management Cell (PDMC)

Background:

- In 2016, the Finance Ministry initiated the Public Debt Management Cell as a preliminary step towards forming a Public Debt Management Agency (PDMA).
- This cell, initially part of the RBI, is planned to evolve into an independent entity with statutory status, separate from the RBI.
- The objective is to transfer the debt management responsibilities from the RBI to a specialized, autonomous agency.

Structure and Composition of PDMC:

- **Leadership:** The PDMC is led by the Joint Secretary (Budget) from the Department of Economic Affairs.
- **Transition Committee:** A Joint Implementation Committee has been established to facilitate the transition from PDMC to PDMA.
- **Supervision:** The operation of PDMC is overseen by the Monitoring Group on Cash and Debt Management.
- **Staffing:** The PDMC comprises 15 debt managers drawn from various units including the RBI, Budget Division, and other government departments.

Primary Responsibilities:

- **Debt Planning:** Formulating strategies for government borrowing, covering both market and other forms of borrowings.
- **Liability Management:** Overseeing the government's debt obligations.
- **Cash Balance Monitoring:** Keeping track of government cash balances.
- **Cash Forecasting:** Enhancing the prediction accuracy of cash requirements.
- **Market Readiness:** Ensuring liquidity and efficiency in the market for government securities issuance.
- **Advisory Role:** Advising the government on capital market engagements, investment strategies, and managing interest rates on small savings.
- **Database Development:** Creating an Integrated Debt Database System as a centralized, real-time repository of all government liabilities.

This initiative represents a significant move towards specialized and efficient management of India's public debt, aiming for enhanced fiscal discipline and market efficiency.

PERSPECTIVES ON DEFICIT AND DEBT (NK SINGH)

The relationship between fiscal deficits and their impact on economies is a complex and debated topic. One major concern is the potential inflationary effect of deficits, particularly when the economy is operating at full capacity. Conversely, in times of economic slack, deficits can stimulate demand and lead to a "crowding in" of private investment.

Perspectives on Deficit

1. **Inflationary Pressures and Crowding Out in Boom Phases**
   - (a) **Inflationary Concerns:** Government spending or tax cuts can increase aggregate demand, potentially outpacing the economy's capacity to supply goods and services, leading to inflation.
   - (b) **Crowding Out in Boom Phases:** Full utilization of economic resources can result in government borrowing competing with private investment, potentially reducing the availability of funds for the private sector.
2. **The Role of Fiscal Deficits in Economic Stimulus**
   - (a) **Keynesian Perspective:** Economists, including Lord Keynes, advocate for controlled fiscal deficits, especially during crises, to boost economic activity through increased public investment.
   - (b) **Crowding In during Downturns:** In periods of economic slowdown or recession, increased government spending can boost demand, pulling the private sector into increased production to meet consumer needs.
3. **Assessing the Need for Fiscal Deficits**
   - (a) **Long-Term Benefits:** Public investment, particularly in infrastructure, can benefit future generations, provided returns exceed the cost of borrowing.
   - (b) **Debt Sustainability:** The sustainability of debt depends on the "interest rate growth rate differential," where a higher growth rate than the interest rate leads to debt sustainability.
4. **Evidence from Economic Surveys**
   - (a) **Counter-Cyclical Fiscal Policy:** Economic surveys suggest the importance of counter-cyclical fiscal policies to smooth economic cycles, especially during crises like Covid-19.
   - (b) **Fiscal Multipliers:** Studies indicate that fiscal policies are more effective during recessions than expansions, with a counter-cyclical stance reducing output volatility.
   - (c) **Debt-to-GDP Ratio Dynamics:** In India, higher GDP growth correlates with a decline in the debt-to-GDP ratio, highlighting the importance of growth in managing public debt.

(d) **Crowding Out Reconsidered:** Recent research questions the notion of crowding out in rapidly growing economies, suggesting that the supply of savings may expand with income growth.

5. **Public Investment and Private Sector Dynamics**

(a) **Complementary Roles:** Public investment may complement private investment in developing countries, with evidence suggesting no crowding out in India post-liberalization.

(b) **Impact on Unemployed Resources:** Increased government spending in sectors with large fiscal multipliers, such as infrastructure, may stimulate private investment and utilize unemployed resources.

In conclusion, Fiscal deficits can stimulate the economy, but they depend on many factors, such as the type and timing of public spending. Deficits should balance growth and stability, and consider long-term effects on debt and private investment. A thorough and forward-looking evaluation is needed to use fiscal policies wisely and manage the complex relationship between government and private spending.

Perspectives on Debt

In nations and economies, debt refers to the financial obligations incurred by a government through borrowing. This includes loans from various sources, such as domestic or international entities, bonds, and other debt instruments. Governments borrow to fund public expenditures, infrastructure projects, or manage budgetary shortfalls.

National debt, or public debt, represents the total owed by a government to external creditors and its citizens. This borrowing aims to address fiscal needs and stimulate economic growth. Terms like interest rates and repayment schedules are crucial factors influencing a nation's economic health.

Managing national debt is vital for economic stability, as excessive debt can impact creditworthiness. Prudent use of debt supports economic development. Assessing national debt often involves considering the debt-to-Gross Domestic Product (GDP) ratio, indicating a country's ability to manage and service debt relative to its economy's size.

1. **State Government Financing under Central Facilitation**

(a) *12th Finance Commission Recommendations:* Central Government facilitates external financing for states.

(b) *Sovereign Guarantee:* Central Government acts as guarantor for state borrowings from multilateral and bilateral agencies.

2. **Components of Government of India Debt and Liabilities**

(a) *Internal Debt:* Borrowings through Debt Securities like Treasury Bills and Dated Securities in the domestic market.

(b) *External Debt:* Borrowings from other governments, multilateral agencies, and Foreign Portfolio Investors (FPI).

(c) *Public Account Liability:* Inclusion of National Small Savings Schemes like Public Provident Fund and Kisan Vikas Patra.

(d) *Off-Budget Liabilities:* Financial obligations of entities owned or controlled by the Central Government.

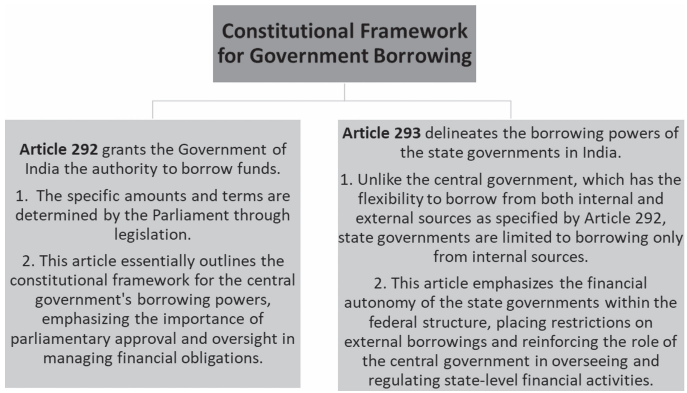

Constitutional Framework for Government Borrowing
Article 292 grants the Government of India the authority to borrow funds.
1. The specific amounts and terms are determined by the Parliament through legislation.
2. This article essentially outlines the constitutional framework for the central government's borrowing powers, emphasizing the importance of parliamentary approval and oversight in managing financial obligations.
Article 293 delineates the borrowing powers of the state governments in India.
1. Unlike the central government, which has the flexibility to borrow from both internal and external sources as specified by Article 292, state governments are limited to borrowing only from internal sources.
2. This article emphasizes the financial autonomy of the state governments within the federal structure, placing restrictions on external borrowings and reinforcing the role of the central government in overseeing and regulating state-level financial activities.

Fig. 9.23

3. **Public Debt and Its Security**

(a) *Public Debt Definition:* Combination of Internal Debt and External Debt.

(b) *Security against Consolidated Fund:* Public Debt is contracted against the Consolidated Fund of India, ensuring accountability and financial stability.

IGNITE YOUR MIND

Considering the diverse perspectives on fiscal deficits and their impact on economic growth, do you think there is a universally applicable approach to managing fiscal policy, or should it be context-specific, taking into account the economic conditions of each country?

MONETIZATION OF DEFICIT AND DEFICIT FINANCING

Monetization of deficit and deficit financing play a crucial role in shaping the fiscal policies of governments worldwide. These practices are often employed to address economic challenges, stimulate growth, or manage budget shortfalls.

- **Deficit Financing:** Deficit financing occurs when a government spends more money than it collects in revenue, resulting in a budget deficit. Governments resort to deficit financing for various reasons, such as funding public infrastructure projects, addressing economic recessions, or responding to emergencies. The deficit is typically financed through borrowing, either domestically or internationally, issuing bonds, or printing money.

- **Monetization of Deficit:** Monetization of deficit refers to the process of financing a budget deficit by directly creating new money. In this scenario, central banks, often in collaboration with the treasury, may purchase government securities or debt instruments directly from the government. The funds for these purchases are typically created through the central bank's ability to issue currency.

Particular	Monetization of Deficit	Deficit Financing
Definition	The process of financing a budget deficit by directly creating new money, often involving the central bank purchasing government securities.	The broader concept of funding a budget deficit, which can be achieved through various means, including borrowing, issuing securities, or creating new money.
Primary Actor	Central Bank (in collaboration with the treasury)	Government (Treasury/Finance Ministry)
Mechanisms	Open Market Operations (purchase of government securities). Direct lending to the government by creating new money.	Borrowing through issuing bonds, Issuing securities such as treasury bills, Creating new money (printing money) in extreme cases.
Source of Funds	Newly created money by the central bank.	Borrowed funds from the public, financial institutions, or other governments.
Inflationary Impact	Can lead to inflation due to the increase in the money supply without a corresponding increase in goods and services.	Inflationary impact is possible, particularly if deficit financing involves creating new money. However, it may not be as direct or immediate as in monetization.
Market Mechanism Distortion	Direct involvement of the central bank in purchasing government securities may distort market mechanisms.	Relies on market mechanisms like bond markets and can lead to more conventional market interactions.
Interest Rates Impact	Can influence short-term interest rates as a result of open market operations.	Impact on interest rates is more indirect and depends on various factors, including market demand for government securities.
Exchange Rate Impact	May contribute to the depreciation of the currency due to inflation concerns.	Impact on exchange rates is generally influenced by market perception, inflation, and overall economic conditions.
Debt Accumulation	May contribute to the accumulation of national debt over time.	Results in the accumulation of debt when funds are borrowed, but the direct creation of new money is not the primary cause.
Long-Term Consequences	Can lead to a cycle of debt dependency and potential challenges in controlling inflation.	While accumulating debt is a concern, the focus is on managing debt through sustainable fiscal policies.
Examples in History	Instances of hyperinflation, such as in some developing countries during economic crises.	Common practice in various economies, especially during economic downturns or periods of significant public spending.

Deficit Financing

- **Reasons for Deficit Financing:**
  - **Economic Stimulus:** During economic downturns, governments may increase spending to stimulate economic activity and employment.
  - **Infrastructure Development:** Funding major infrastructure projects that contribute to long-term economic growth.
  - **Emergency Response:** Addressing unforeseen events such as natural disasters, pandemics, or geopolitical crises.
- **Methods of Financing Deficit:**
  - **Borrowing:** Governments issue bonds or borrow funds domestically and internationally to cover budget shortfalls.
  - **Issuing Securities:** Governments sell financial instruments like treasury bills and bonds to investors to raise capital.
  - **Printing Money:** In extreme cases, governments may resort to printing more money, although this can lead to inflationary pressures.

Monetization of Deficit and Deficit Financing – India's Case

- Before 1997, the government financed its deficit by borrowing from the RBI through ad hoc Treasury Bills.
- The RBI would print money and give it to the government in exchange for bonds. This was called direct monetization of the deficit.

- In 1997, the government and the RBI agreed to stop this practice and introduced a system called WMA (Ways and Means Advance) to provide short-term advances to the government.
- The FRBM Act of 2003 banned direct monetization of the deficit, except in some cases.
- The RBI also agreed to use Open Market Operation (OMO) in the secondary market to manage liquidity and not to support government borrowing.

Under What Circumstances Should The Government Consider Direct Monetization?

Direct monetization becomes a viable option when there is a shortage of liquidity in the economy, and banks lack sufficient funds. In such a scenario, if the government attempts to borrow from banks, it could worsen the liquidity situation, leading to an increase in interest rates. This, in turn, could impede investments—the very aspect the government is actively pursuing for economic recovery. In such situations, the government may opt for direct monetization. However, if banks have surplus liquidity, the government should initially explore borrowing from them.

FISCAL COUNCIL AND FSDC

A fiscal council is an independent and non-partisan institution established by a government to provide analysis, oversight, and advice on fiscal policy matters. The primary purpose of a fiscal council is to enhance the transparency, credibility, and effectiveness of fiscal policies by offering an unbiased evaluation of government finances and economic conditions.

Key Functions of a Fiscal Council Typically Include

- **Fiscal Analysis:** Conducting in-depth analysis of fiscal policies, government budgets, and economic forecasts to assess their sustainability and implications for public finances.
- **Budget Oversight:** Reviewing the government's budgetary proposals, expenditures, and revenue projections to ensure they align with fiscal targets and long-term fiscal sustainability goals.
- **Economic Forecasting:** Providing independent economic forecasts and projections to assess the accuracy and realism of government economic assumptions underlying fiscal policies.
- **Public Reporting:** Communicating findings and assessments to the public, policymakers, and relevant stakeholders to enhance transparency and accountability in fiscal matters.
- **Policy Recommendations:** Offering recommendations and alternative strategies to improve fiscal policies, address economic challenges, and promote long-term fiscal responsibility.
- **Monitoring Compliance:** Assessing the government's compliance with fiscal rules, targets, and commitments, thereby promoting fiscal discipline.
- **Long-Term Fiscal Planning:** Assisting in the development of long-term fiscal plans that consider demographic changes, economic trends, and other factors affecting future public finances.

The Necessity of a Fiscal Council in India

- **Budget Discrepancies:** Throughout history, interim budgets in India have consistently shown a pattern of overestimating revenue growth and underestimating expenditure growth.
  - An examination of budget figures since 1991 by the Economic and Political Weekly Research Foundation revealed that deviations from budget estimates, particularly in interim budgets, tend to be remarkably high.
  - The finance ministry's track record in forecasting projections has been consistently poor, with a tendency to overstate revenue projections and understate expenditures, both in interim and regular budgets.
- **Tax Administration Challenges:** The combination of overly ambitious revenue targets and a lack of transparency in tax administration often leads tax authorities to exceed their mandates in an attempt to meet unrealistic targets.
  - A 2017 report by the Comptroller and Auditor General (CAG) identified 'irregular' and 'unwarranted' methods employed by the tax department to achieve their tax targets.
- **Manipulation of Fiscal Figures:** When the government falls short of revenue or expenditure targets, it resorts to various cover-up strategies.
  - While oil bonds were previously used to dress up fiscal deficit numbers, the current preferred method involves the disinvestment of public sector enterprises to enhance government stake sales.
  - In recent years, the country's largest insurer, Life Insurance Corp. of India (LIC), has played a pivotal role in supporting the government's divestment program.
- **Coordination Challenges between GST Council and Finance Commission:** The GST Council and the Finance Commission typically operate independently, lacking adequate awareness of each other's actions.
  - There is a clear need for coordination between these two entities to ensure synergy and alignment in their objectives.
- **Regulating Central Government Borrowings:** While Article 293 imposes constitutional constraints on the borrowings of State governments, there is a notable absence of such restrictions on the Central government.
  - Implementing limitations on borrowings by the Central government is essential for maintaining fiscal discipline and accountability.

Advantages of Having a Fiscal Council

- **Enhanced Transparency:** An impartial report to Parliament elevates the quality of discourse and fosters increased transparency regarding public funds.
- **Prevention of Populist Government Expenditure:** Independent analyses of policies deter the tendency for populist spending, promoting objectivity over political gains.
- **Elevated Public Awareness:** Scientific cost estimates and forecast assessments contribute to heightened public awareness regarding fiscal implications, aiding in a better understanding of budgetary constraints.
- **Improved Accuracy:** The presence of an independent **f**iscal council enhances the accuracy of fiscal projections, facilitating adherence to fiscal rules. Acting as a conscience keeper, the fiscal council monitors the implementation of rule-based policies.
- **Enhanced Accountability:** Fiscal councils often instill discipline in lawmakers through 'comply or explain' obligations. Governments are required to justify any deviation from the fiscal council's perspectives, promoting increased accountability.

Challenges of Establishing a Fiscal Council in India

- **Erosion of Finance Ministry's Authority:** Allowing external estimates to supersede those of the Finance Ministry could undermine its accountability. If projections prove inaccurate, the Finance Ministry may deflect blame onto the fiscal council, diluting its own responsibility.
- **Executive Control Challenges for Elected Government:** There's concern that the establishment of a fiscal council might hinder the government's ability to adapt fiscal rules based on evolving situations. The fear is that it could lead to the imposition of inflexible regulations for fiscal prudence.
- **Potential Bureaucratic Redundancy:** Introducing a fiscal council may lead to bureaucratic redundancy, with overlapping responsibilities that could hinder the efficiency of decision-making processes.
- **Financial Burden on Government Resources:** Establishing and maintaining a fiscal council would require financial resources. This could pose an additional burden on government funds that might be allocated for other critical needs.
- **Expertise and Resource Challenges:** Ensuring the fiscal council is equipped with the necessary expertise and resources to make accurate assessments poses a challenge. A shortage of qualified professionals could compromise the quality of fiscal analysis.
- **Conflict of Opinions:** The presence of an independent fiscal council may lead to conflicts of opinion between its assessments and the government's fiscal policies, potentially creating discord and hindering effective governance.
- **Possibility of Overly Conservative Fiscal Policies:** Fear exists that a fiscal council, in an attempt to ensure prudence, might recommend overly conservative fiscal policies, impeding the government's ability to implement necessary stimulus measures during economic downturns.
- **Impact on Policy Flexibility:** Critics argue that a fiscal council may limit the government's flexibility in responding to unique economic challenges, as adherence to set rules may restrain the adoption of unconventional but necessary fiscal measures.
- **Complication of Decision-Making Processes:** Introducing an additional layer of oversight may complicate decision-making processes, potentially slowing down responses to urgent economic situations due to the need for consensus between the government and the fiscal council.

Financial Stability and Development Council (FSDC)

The Financial Stability and Development Council (FSDC) is an apex-level body in India that was established to strengthen and institutionalize the mechanism for maintaining financial stability, promoting financial sector development, and ensuring inter-regulatory coordination.

The FSDC was set up in December 2010 by an Executive Order of the Union Government as a **non-statutory measure in response** to the global financial crisis of 2007-08, with the objective of addressing systemic risks to the financial stability of the country. The Raghuram Rajan Committee (2008) on financial sector reforms first proposed the creation of FSDC.

Composition

- **Initial compositions**
  - **The membership of the FSDC is discussed below**
  - The Finance Minister is the Chairman of the FSDC.
  - Members of FSDC include Heads of the Financial Sector Regulators listed below:
    - Reserve Bank of India (RBI)
    - Insurance Regulatory and Development Authority (IRDA)
    - Securities and Exchange Board of India (SEBI)
    - Pension Fund Regulatory and Development Authority (PFRDA)
    - Other members are Finance Secretary, Chief Economics Advisor and Secretary of the Department of Financial Services.
- **Membership reforms (Later additional members were added)**
  - In 2018, The government has reconstituted the Financial Stability and Development Council.
  - New members added to the FSDC include:
    - Minister of State responsible for the Department of Economic Affairs (DEA).

- Secretary of the Department of Electronics and Information Technology.
- Revenue Secretary.
- Chairman of the Insolvency and Bankruptcy Board of India (IBBI).

- The restructuring aims to make the FSDC more broad-based.
- The changes are intended to incorporate adjustments in the economic regulatory framework of the country.

- **The FSDC sub-committee** is headed by the **Governor of RBI.**
- The Council can **invite experts to its meeting if required.**

Functions of FSDC in India

The Financial Stability and Development Council (FSDC) in India performs several important functions to ensure financial stability and promote the development of the financial sector. Here are the key functions of the FSDC:

The functions of the FSDC are designed to create a comprehensive and integrated approach to managing and developing the financial sector, contributing to the overall economic stability and growth of the country.

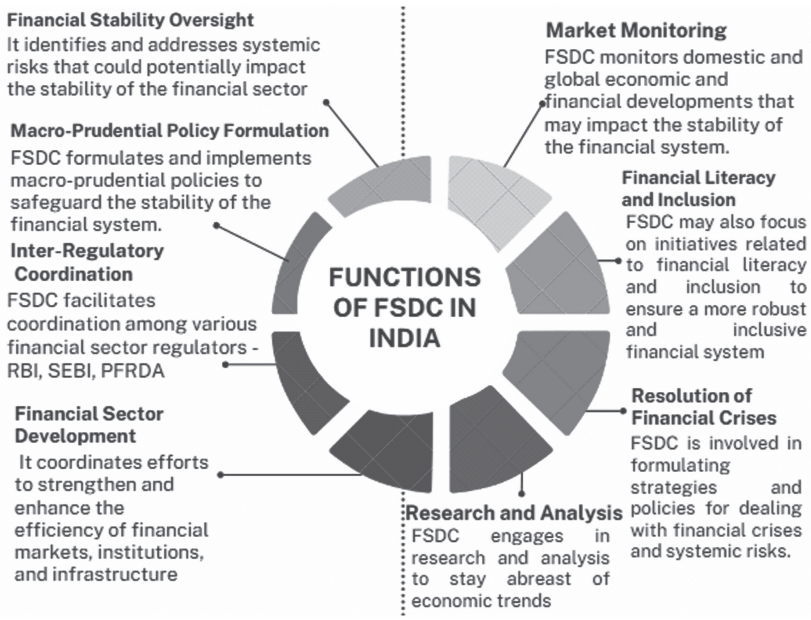

FUNCTIONS OF FSDC IN INDIA
Financial Stability Oversight
It identifies and addresses systemic risks that could potentially impact the stability of the financial sector
Macro-Prudential Policy Formulation
FSDC formulates and implements macro-prudential policies to safeguard the stability of the financial system.
Inter-Regulatory Coordination
FSDC facilitates coordination among various financial sector regulators - RBI, SEBI, PFRDA
Financial Sector Development
It coordinates efforts to strengthen and enhance the efficiency of financial markets, institutions, and infrastructure
Market Monitoring
FSDC monitors domestic and global economic and financial developments that may impact the stability of the financial system.
Financial Literacy and Inclusion
FSDC may also focus on initiatives related to financial literacy and inclusion to ensure a more robust and inclusive financial system
Resolution of Financial Crises
FSDC is involved in formulating strategies and policies for dealing with financial crises and systemic risks.
Research and Analysis
FSDC engages in research and analysis to stay abreast of economic trends

Fig. 9.24

FINANCIAL ALLOCATION FROM UNION TO STATES

The transfer of funds from the central government to the states in India is a crucial aspect of the country's federal financial system.

The Constitution delineates the authority to levy taxes and allocate expenditure between the Union and state governments. It specifies the areas where either the Union, the state, or both have the power to impose taxes, as outlined in the Concurrent List of the Constitution. Additionally, the 73rd and 74th Amendments to the Constitution have conferred certain financial powers upon local governments, granting them limited autonomy in financial matters.

The Various Ways of Fund Transfer From Union to State Government in India are

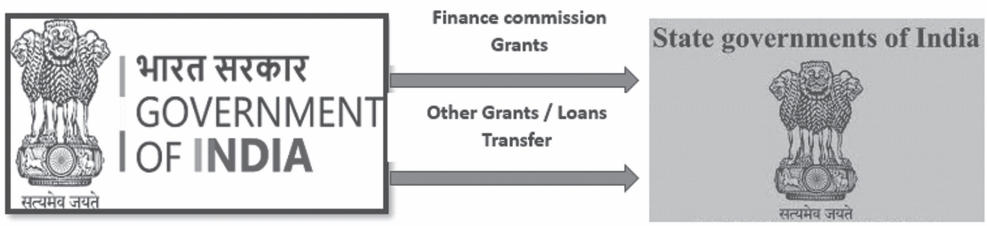


Fig. 9.25

1. Finance Commission Grants Under Article 280

Composition and Role of the Finance Commission

- **Appointment:** The President of India is required to appoint a Finance Commission every five years or earlier, if deemed necessary.
- **Composition:** The Commission includes a chairman and four other members.
- **Primary Function:** Its main role is to recommend the division of tax revenues between the Centre and the states and suggest principles for grants-in-aid.

Key Responsibilities of The Finance Commission

- **Vertical Devolution:** The Commission advises on how the net proceeds of taxes should be shared between the central government and the states.
- **Grants-in-Aid Principles:** It also recommends the criteria for grants-in-aid given by the Centre to the states from the Consolidated Fund of India.
- **Augmentation of State Funds:** It suggests ways to improve the consolidated funds of states to support local bodies like Panchayats and Municipalities.
- **Other Financial Matters:** The Commission addresses any other financial issues referred to it by the President.

15th Finance Commission Recommendations (2021-26)

(i) Vertical Devolution:

- **Share of Central Taxes for States:** States are recommended to receive **41%** of the divisible pool of Central taxes.
- **Exclusions from Divisible Pool:** The pool excludes costs such as tax collection expenses, cess and surcharge, revenue from Union Territories, and National Calamity Contingent Duty.

Horizontal Distribution Parameters

Parameter	Weightage (%)
Income Distance	45
Population (2011 Census)	15
Demographic Performance	12.5
State Area	15
Forest and Ecology	10
Tax and Fiscal Effort	2.5

(ii) Grants-in-Aid (Article 275): (these are charged on Consolidated Fund of India and tied grants)

Revenue Deficit Grants

- After allocating 41% of funds, certain states face revenue deficits.
- The Finance Commission suggests grants to offset these post-devolution revenue gaps.
- The recommendations are designed to correct fiscal capacity issues, avoiding incentives for insufficient revenue collection or overspending.
- For the fiscal year 2021-22, the 15th Finance Commission recommended such grants for 17 states.
- By the fiscal year 2025-26, the number of states eligible for these grants is projected to reduce to six.

Local Body Grants

- **Total Allocation:** An aggregate of ₹ 4,36,361 crores has been recommended for local governments over a five-year period.
- **Utilization:** 60% of these funds are earmarked for priorities like drinking water and sanitation, while 40% is untied for use at the discretion of local bodies.
- **Shift in Urban-Rural Distribution:** The distribution ratio between urban and rural bodies is set to change from **67.5 : 32.5 to 65 : 35** over the period.
- **State-Level Distribution Criteria:** The funds are allocated based on 90% population and 10% area of the states.

Disaster Management Grants

- **Centre-State Contribution Ratio:** The recommended contribution ratio is 75% by the Centre and 25% by the States. For Northeastern states, this ratio is 90:10.
- **Fund Allocation:** The total allocation to states is divided into the State Disaster Response Fund (SDRF) with 80% and the State Disaster Mitigation Fund (SDMF) receiving 20%.

Sector-Specific Grants

- **These grants are primarily performance-based incentives linked to specific benchmarks.**
  - **Health Sector Grants:** Allocated for improvements in the health sector.
  - **School Education Grants:** Focused on enhancing school education systems.
  - **Higher Education Grants:** Aimed at advancing the quality and infrastructure
  - **Agricultural Reforms Implementation:** These incentives cover four key areas: Land lease reforms, Sustainable and efficient water use in agriculture, Export promotion, Contributions to the Atma Nirbhar Bharat initiative, specifically in oilseeds, pulses, and wood-based products.
  - **PMGSY Road Maintenance**
  - **Judiciary Grants:**
  - **Statistics Improvement Grants:**
  - **Aspirational Districts and Blocks:**
  - **Power Sector:**

State-Specific Grants

- Designed to meet specific needs and financial shortcomings of states, beyond what is covered by the formula-based 41% allocation and other sector-specific grants.
- Intended for all 28 states.
- Focus areas include:
  - Addressing various social welfare needs.
  - Improving administrative governance and related infrastructure.
  - Promoting conservation and sustainable use of water resources
  - Protecting and preserving cultural heritage and historical monuments.
  - Developing and maintaining high-cost physical infrastructure projects.
  - Enhancing the tourism industry within the states.

Establishment of The Modernisation Fund For Defence and Internal Security in India

The **15th Finance Commission** recognized the need to enhance spending on the **capital requirements for defense and internal security.** Consequently, it recommended establishing a dedicated fund, potentially named **Rashtriya Suraksha Naivedyam Kosh** or a similar title, by the Union Government. This fund is aimed at **addressing the discrepancy between the anticipated budgetary needs and the allocated budget** for capital expenditures in defense and internal security.

Key purposes of the fund include:

1. Capital investment for the modernization of defense services.
2. Investment in capital for Central Armed Police Forces (CAPFs) and the modernization of state police forces.
3. A portion allocated as a welfare fund for soldiers and paramilitary personnel.

The fund will be governed by standard rules for administration, public reporting, and will be audited by the Comptroller and Auditor General (CAG).

Four primary sources will contribute to this fund:

1. Transfers from the Consolidated Fund of India.
2. Proceeds from disinvestment of Defense Public Sector Enterprises (DPSEs).
3. Revenue from monetizing surplus defense land, including payments for land used by state governments and for public projects, and recovery of costs from encroached land.
4. Income from the future transfer of defense land to state governments and for public projects.

2. Additional Transfers From Central to State Governments

- Beyond the regular transfers, states receive various other forms of financial support from the Central Government. This includes **Special Assistance Grants, Additional Central Assistance in both grants and loans, and financial aid from the National Disaster Response Fund (NDRF).**

Central Sector and Centrally Sponsored Schemes

- **Administration and Communication:** The Central Sector Schemes (CSs) and Centrally Sponsored Schemes (CSSs) funding outlays over a Finance Commission cycle are communicated by the Public Finance (Central) Division of the Department of Expenditure, Ministry of Finance. This is done in consultation with the Budget Division of the Department of Economic Affairs.
- **Outcome Budgets:** The Public Finance Division also prepares outcome budgets for all Central Ministries/ Departments in coordination with NITI Aayog. This involves setting measurable outcomes for CSSs and CSs within a medium-term framework, with targeted physical and financial outputs annually.

Centrally Sponsored Schemes (CSSs)

- **Funding and Implementation:** In CSSs, a portion of the funding is shared by the states, with varying ratios like 50 : 50, 70 : 30, 75 : 25, or 90 : 10. These schemes are implemented by the state governments.
- **Formulation and Purpose:** CSSs are developed for subjects under the State List to encourage states to focus on areas needing more attention.
- **Funding Channels:** Until 2013-14, CSS funds were channeled through both the consolidated funds of the states and directly to state/district level bodies. However, from 2014-15, direct transfers to state agencies were stopped, and all CSS funds were routed through the states' consolidated funds.

Rationalization of CSSs by NITI Aayog

- A sub-group of Chief Ministers, under the Governing Council of NITI Aayog, was established for rationalizing CSSs.
- They recommended limiting CSSs to a maximum of 30.
- **The CSSs were proposed to be classified into three categories:**
  - **Core Schemes:** Focused on the National Development Agenda, involving collaborative efforts between the Centre and states. Example: Pradhan Mantri Gram Sadak Yojana.
  - **Core of the Core Schemes:** Priority schemes for social protection and inclusion, forming the primary focus of the National Development Agenda. Example: MGNREGA.
  - **Optional Schemes:** Schemes that states can choose to implement, with allocated funds provided as a lump sum by the Ministry of Finance.

Funding Pattern Between Core of The Core Scheme and Core Schemes

Scheme Category	North Eastern and Himalayan States	Other States
Core of the Core Schemes	No change in the erstwhile funding pattern	No change in erstwhile funding pattern
Core Schemes	Center: State = 90 : 10	Center : State = 60 : 40

CONCLUSION

India's fiscal policy walks a tightrope between fueling aspirations and maintaining prudence. While recent reforms show progress, striking the right balance between growth-oriented investments and manageable deficits remains critical. Continuous adaptation and policy refinement are crucial for India to walk this fiscal tightrope with confidence and unlock its full potential.

Financial Markets

10

INTRODUCTION

Financial markets serve as platforms where buyers and sellers meet and engage in the exchange of various financial instruments, such as stocks, bonds, currencies, and derivatives. These markets can be broadly categorized into two main groups:

Money Markets

- Focus on **short-term (less than one year)** financial instruments with high liquidity.
- Participants are mainly financial institutions, banks, central banks, and highly rated corporations.
- Less risky than capital markets.
- Divided into two sub-markets:
  - **Primary Market:** where companies issue new securities for the first time (IPO). Transactions occur between the issuer and investors (e.g., the company selling bonds to a group of investors).
  - **Secondary Market:** where previously issued securities are traded among investors themselves (e.g., investors buying and selling the bonds amongst themselves).

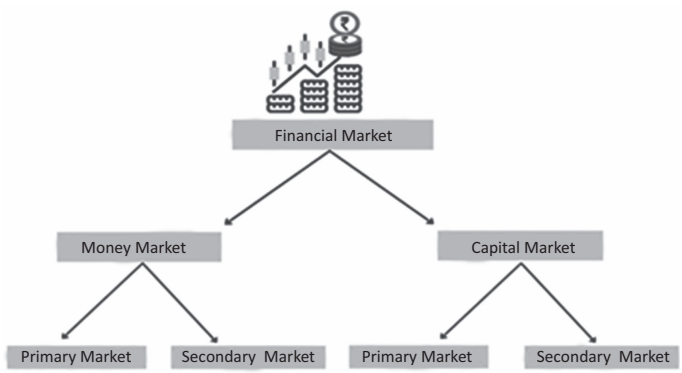


Fig. 10.1: Components of Financial Market

Capital Markets

- Deal in **long-term (more than one year)** debt and equity securities.
- Also, have primary and secondary markets.

MONEY MARKET

- A segment of the financial system where **short-term borrowing and lending happen** (overnight to 1 year).
- Deals in highly liquid, low-risk instruments like call money, certificates of deposit, and commercial paper.
- Plays a crucial role in ensuring the smooth functioning of the entire economy.

Key Objectives of Money Markets

- **Short-term financing:** It provides immediate funding solutions for businesses and individuals.
- **Liquidity management:** It helps manage cash positions efficiently, allowing quick access to funds when needed.
- **Low-risk investments:** It secure investment options with stable returns, ideal for parking short-term surplus funds.
- **Benchmark interest rates:** Establishes reference rates used to price other financial instruments.
- **Monetary policy implementation:** Money market assists central banks in managing overall economic activity through liquidity and interest rate adjustments to control inflation.
- **Market stability and transparency:** It promotes a fair and transparent marketplace through regulations and oversight.

Evolution of India's Money Market

The Indian money market boasts a rich history, dating back to the late 19th century. Let's explore its fascinating evolution:

- **Pre-Independence Era (Late 19th century to 1947)**
  - Informal and unregulated market dominated by indigenous bankers (Shroffs and Mahajans).
  - The bill market flourished, with treasury bills, commercial bills, and promissory notes gaining traction.
- **Post-Independence Era (1947 to 1991)**
  - The Reserve Bank of India (RBI) assumed a more active role, introducing regulations and instruments for market development.
  - **Key milestones:**
    - Issue of Treasury Bills.
    - Establishment of the Discount and Finance House of India (DFHI).
    - Introduction of Certificates of Deposit (CDs) and Commercial Papers (CPs).
- **Liberalisation and Reforms (1991 Onwards)**
  - Economic reforms aimed to modernise the financial sector and promote market-oriented policies.
  - **Significant changes in the money market:**

- Introduction of new instruments like interbank call money and term money.
- Implementation of the Negotiated Dealing System (NDS) for trading government securities.
- Establishment of the Securities and Exchange Board of India (SEBI) as the securities market regulator.

- **Technological Advancements and Integration (Late 1990s to present)**
  - Technological advancements and electronic trading platforms transformed the market.
  - **Key developments:**
    - Introduction of the Negotiated Dealing System-Order Matching (NDS-OM) for electronic government securities trading.
    - Establishment of the Clearing Corporation of India Limited (CCIL) for efficient settlement of transactions.
  - Increased participation from various players like banks, financial institutions, corporates, mutual funds, and non-banking financial companies (NBFCs).
  - RBI continues to play a crucial role in regulation and development through policy interventions and measures promoting stability and liquidity.

Building Blocks of Money Market

The money market is a complex ecosystem that facilitates short-term financing, liquidity management, and risk mitigation within the financial system. This intricate structure is built upon several key components:

- **Players**
  - **Banks and Financial Institutions:** These are the primary participants, actively borrowing and lending funds within the market.
  - **Corporations:** Companies leverage the money market to access short-term financing for various needs.
  - **Mutual Funds and NBFCs:** These institutions also participate in seeking investment opportunities and managing liquidity.
  - **Individual Investors:** Though less common, some individuals invest in money market instruments for safety and short-term returns.
- **Regulators**
  - **Central banks and financial regulatory authorities:** These entities play a crucial role in maintaining stability, transparency, and fair practices within the money market through regulations and oversight.
- **Instruments**
  - **Treasury Bills:** Short-term debt instruments issued by the government.
  - **Certificates of Deposit (CDs):** Negotiable instruments issued by banks with fixed maturities and interest rates.
  - **Commercial Paper (CP):** Unsecured promissory notes issued by corporations to raise short-term funds.
  - **Repurchase Agreements (Repos):** Short-term agreements involving the sale and repurchase of securities.
  - **Collateralized Borrowing and Lending Obligations (CBLOs):** Securitized pools of debt instruments.
  - **Money Market Mutual Funds (MMMFs):** Pooled investment vehicles that invest in money market instruments.
- **Market Infrastructure**
  - **Electronic trading systems:** These platforms facilitate efficient and transparent trading of money market instruments.
  - **Clearing entities:** Organisations like the Clearing Corporation of India Limited (CCIL) ensure smooth settlement of trades.
- **Interbank Market**
  - This sub-market facilitates direct borrowing and lending between banks and financial institutions.
  - **Market Pricing**
  - Interest rates play a central role in determining the cost of borrowing and the returns on investments within the money market. Pricing is influenced by various factors such as creditworthiness, market demand and supply, and central bank policies.
- **Transparency**
  - Disclosure of transaction information and regulatory oversight are essential for promoting a fair and transparent environment within the money market.

IGNITE YOUR MIND

Do you think the liberalisation and economic reforms initiated in 1991 have positively contributed to the development of India's money market?

CALL MONEY

Call money, also known as "money at call," is a short-term loan with immediate repayment required upon the lender's demand. Unlike a traditional loan with a fixed repayment schedule, call money offers flexibility for both borrowers and lenders.

Key Features

- **Short-term:** Typically matures **overnight**, but can range from a few days to 14 days.
- **Immediate repayment:** Borrowers must repay the full amount upon the lender's request, with no prior notice required.
- **Unsecured:** No collateral is required, making it a low-risk investment for lenders.

- **Interest-bearing:** Borrowers pay interest on the loan amount, typically calculated on a daily basis.
- **Market-driven rates:** Interest rates fluctuate based on demand and supply in the market.

London Interbank Offered Rate (LIBOR)

- A benchmark interest rate for short-term loans between international banks.
- Calculated and published daily by the Intercontinental Exchange (ICE).
- Being phased out due to recent scandals and replaced by a Secured Overnight Financing Rate (SOFR).

Mumbai Interbank Offered Rate (MIBOR)

- India's benchmark interest rate for short- term loans between banks.
- Determined by a panel of 30 banks and major dealers.
- Introduced in 1998, following the London Interbank Offered Rate (LIBOR).

Uses

- **Managing liquidity:** Borrowers use call money to meet short-term cash needs, such as covering payroll or unexpected expenses.
- **Investing surplus funds:** Lenders invest their idle funds in call money to earn a higher return than traditional savings accounts.
- **Interbank lending:** Banks lend to each other through the call money market to manage their short-term liquidity positions.

Benefits

- **Flexibility:** Offers quick access to funds for borrowers and investment opportunities for lenders.
- **Low risk:** Unsecured nature and short-term maturity minimise the risk for lenders.
- **Market efficiency:** Facilitates efficient allocation of funds between borrowers and lenders.

Notice Money

Notice money is a type of short-term financial instrument used primarily by institutions like banks and financial houses to manage their short-term liquidity needs.

- **Tenure:** Notice money represents loans or deposits with a maturity ranging from **2 days to 14 days.** This makes it slightly longer than call money, which matures overnight, but shorter than term money, which can extend beyond 14 days.
- **Interest:** Interest rates on notice money are typically determined by the demand and supply of short-term funds in the market. They tend to be higher than overnight call money rates but lower than longer-term term money rates.
- **Unsecured:** Notice money is generally uncollateralized, meaning borrowers don't need to provide any specific assets as security for the loan. This makes it a relatively flexible and accessible financing option.
- **Purpose:** Institutions use notice money for various purposes, such as:
  - Meeting temporary fluctuations in their cash flow.
  - Taking advantage of short-term investment opportunities.
  - Covering unexpected cash outflows.

Limitations

- **Uncertainty:** Borrowers face the risk of sudden repayment demands, impacting their cash flow management.
- **Fluctuations in rates:** Interest rate fluctuations can lead to higher borrowing costs for borrowers and lower returns for lenders.

Examples of Call Money Instruments

- **Commercial Paper:** Unsecured debt instruments issued by corporations.
- **Certificates of Deposit (CDs):** Time deposits offered by banks with a fixed interest rate.
- **Treasury Bills:** Short-term government debt instruments.

TREASURY BILLS

Treasury bills (T-bills) serve as short-term money market instruments utilized by the Reserve Bank of India (RBI) to address government liquidity needs, contributing to fiscal deficit reduction. These zero-coupon promissory notes, acquired at a discount and redeemed at face value upon maturity, play a crucial role in the RBI's efforts to regulate the economy's total money supply and generate funds.

Types of Treasury Bills (T-Bills)

T-bills offer a variety of short-term investment options for individuals and institutions, for instance:

- **14-Day Treasury Bills**
  - **Maturity:** 14 days from the issue date.
- **91-Day Treasury Bills**
  - **Maturity:** 91 days from the issue date.
- **182-Day Treasury Bills**
  - **Maturity:** 182 days from the issue date.
- **364-Day Treasury Bills**
  - **Maturity:** 364 days from the issue date.

State Development Loans

- State development loans are bonds issued by state governments in India to fund their fiscal deficit.
- They are similar to central government securities, but they have a higher interest rate and a lower credit risk.
- They are auctioned by the RBI and traded electronically.
- They are one of the most secure and liquid forms of investment in India
- SDLs are typically issued for maturities ranging from 1 year to 10 years, with the most common being 5-7 years.

Benefits of SDLs

- **Financing development projects:** SDLs enable states to undertake critical infrastructure projects in areas like roads, bridges, electricity, healthcare, and education.
- **Boosting economic growth:** Increased spending on infrastructure and development projects stimulates economic activity and creates jobs.
- **Financial independence:** SDLs give states greater flexibility in managing their finances and pursuing their own development goals.
- **Alternative investment option:** For investors, SDLs offer a relatively safe and secure investment option with attractive returns compared to other fixed-income instruments.

Challenges of SDLs

- **Creditworthiness concerns:** The financial health of individual states can vary, leading to concerns about potential defaults on SDLs.
- **Liquidity risk:** Compared to GOI securities, SDLs can be less liquid, meaning buying and selling them quickly might be difficult.
- **Interest rate risk:** Rising interest rates can affect the price of existing SDLs, leading to potential losses for investors.

Key Points to Remember

- The holding period for each T-bill type remains fixed, but face value and discount rates can vary based on RBI's funding needs and monetary policy.
- The Reserve Bank of India releases a T-bill auction calendar before each auction, specifying the date, amount, and maturity details.

Advantages of Treasury Bills

Treasury bills (T-bills) are short-term debt instruments issued by the government, offering investors a secure and reliable option with several attractive advantages.

- **Safety and Security**
  - **Government-backed:** Guaranteed by the government, minimising the risk of default.
  - **Zero credit risk:** No issuer risk compared to corporate bonds or other debt instruments.
  - **High credit rating:** Typically enjoy the highest credit rating in the country, further bolstering their safety.
- **Predictable Returns**
  - **Fixed interest rates:** Determined at auction and known upfront, allowing for clear return expectations.
  - **Zero-coupon structure:** No periodic interest payments, but the difference between the purchase price and the face value at maturity guarantees your return.
  - **Low risk of interest rate fluctuations:** Short maturities minimise exposure to market volatility.
- **Liquidity and Flexibility**
  - **Highly tradable:** Easily buy and sell T-bills in the secondary market, ensuring quick access to funds.
  - **Variety of maturities:** Choose from maturities ranging from 14, 182 and 364 days, catering to specific needs.
  - **Low investment threshold:** Start with as little as ₹ 25,000/-, making them accessible to a wider range of investors.
- **Other Benefits**
  - **Cost-effective:** Low transaction costs compared to other investment options.
  - **Market benchmark:** T-bill yields serve as a reference point for other short-term interest rates.
  - **Diversification tool:** Can help diversify your portfolio and reduce overall risk.
  - **Supporting the government:** Investing in T-bills contributes to financing government operations.

Limitations of Treasury Bills

While Treasury bills offer safety and security, they come with some drawbacks compared to other investment options:

- **Lower Returns**
  - **Government-backed sacrifice:** Compared to the potentially higher returns of stocks or mutual funds, T-bills offer lower yields due to their minimal risk profile.
  - **Zero-coupon structure:** No regular interest payments which means your return is limited to the difference between purchase price and face value, capping potential gains.
  - **Fixed returns:** Unlike investments influenced by market fluctuations, T-bill returns remain stagnant regardless of economic conditions, limiting potential growth.

- **Limited Growth Potential**
  - **Market disconnect:** Unlike equity or debt funds that benefit from market upswings, T-bill returns remain unaffected by positive market movements, limiting the potential for higher returns.
  - **Inflation risk:** T-bill returns may not keep pace with inflation, potentially eroding your purchasing power over time.

CASH MANAGEMENT BILLS

Cash Management Bills (CMBs) are brief-term bills the government releases to fulfil its urgent cash needs. They were introduced in 2010. These bills can mature in a span of a few days to three months. The funds generated from CMB issuances are utilised by the Treasury to address temporary cash deficits and offer emergency funding. The Reserve Bank of India (RBI) issues these bills on behalf of the government. Consequently, CMBs function as short-term money market instruments, aiding the government in managing immediate cash flow discrepancies.

Issuance and Role of The Reserve Bank of India

The Reserve Bank of India acts as the issuer of Cash Management Bills on behalf of the government. The government utilises the funds raised through CMBs to cover temporary cash imbalances, ensuring smooth operations and avoiding disruptions in essential services. The RBI's involvement in the issuance process enhances the credibility and reliability of CMBs in the financial market.

Features of Cash Management Bills

- **Short-Term Maturity:** CMBs are characterised by their brief maturity periods, making them a preferred choice for managing short-term financial exigencies.
- **Versatility in Use:** The funds raised through CMBs can be deployed to address various immediate financial needs, including bridging shortfalls and responding to unforeseen emergencies.
- **Government Backing:** As government-backed instruments, CMBs enjoy a high level of credibility and are considered relatively secure investments.

Significance in Financial Management

- **Effective Cash Flow Management:** CMBs empower the government to effectively manage its cash flow by providing a mechanism to swiftly mobilise funds when needed, minimising the impact of temporary deficits.
- **Emergency Funding Source:** In times of unforeseen financial challenges or emergencies, CMBs serve as a reliable source of emergency funding, allowing the government to respond promptly without disrupting essential services.
- **Market Liquidity:** The issuance of CMBs contributes to market liquidity, providing investors with short-term investment opportunities while offering the government a flexible financing tool.

IGNITE YOUR MIND

Do you think the increasing reliance on T-Bills and CMBs for short-term financing reflects a sound fiscal strategy for the Indian government? Or does it indicate underlying concerns about fiscal health and the potential for increased debt burden and interest costs?

WAYS AND MEANS ADVANCE

In the realm of fiscal management, governments often encounter short-term cash flow challenges that require immediate attention. To address these contingencies, one of the essential financial tools employed by the Reserve Bank of India (RBI) is the Ways and Means Advances (WMA).

Ways and Means Advances refer to a short-term liquidity facility extended by the Reserve Bank of India to the Central and State Governments. This facility allows the governments to meet temporary cash flow mismatches and continue their essential operations smoothly. The WMA framework represents a collaborative mechanism between the RBI and the government to ensure financial stability during periods of fluctuating cash requirements.

Types of Ways and Means Advances (WMA)

- **Normal Ways and Means Advances (WMA):**
  - These are the standard form of WMA, provided by the Reserve Bank of India (RBI) to bridge temporary mismatches between a state's receipts and payments.
  - States can avail themselves of normal WMA up to a pre-determined limit based on their three-year average of actual revenue and capital expenditure.
  - The interest rate charged on normal WMA is typically at the repo rate set by the RBI.
  - These advances must be repaid within 90 days from the date of the loan.
- **Special Drawing Facility (SDF):**
  - This is a specific type of WMA available against the collateral of government-of-India-dated securities held by the state.
  - SDF provides an additional layer of borrowing beyond the normal WMA limit.
  - The interest rate on SDF is generally one percentage point lower than the repo rate, making it slightly cheaper than normal WMA.
  - Similar to normal WMA, SDF advances also need to be repaid within 90 days.

Table Summarising The Key Differences Between The Two Types of WMA

Feature	Normal WMA	Special Drawing Facility (SDF)
Collateral	Unsecured	Government-of-India-dated securities
Borrowing limit	State-specific based on revenue and expenditure	Additional limit beyond normal WMA
Interest rate	Repo rate	Repo rate - 1%
Repayment period	90 days	90 days

Additionally, It's Important to Note that

- Overdrawing beyond the pre-determined limit for normal WMA is considered an "overdraft" and carries a higher interest rate.
- The RBI can decide to modify the WMA limits or interest rates based on economic conditions and the state's financial performance.
- Not all states avail themselves of WMA every year, depending on their individual fiscal situations.

Features of Ways and Means Advances

- **Short-Term Nature:** Providing quick and temporary solution to immediate cash needs.
- **Collaborative Arrangement:** The decision to grant Ways and Means Advances is a collaborative effort between the RBI and the government, promoting a balanced approach to fiscal management.
- **Interest Rates:** The interest rates are typically determined by a mutual agreement between the RBI and the government.
- **Flexible Limits:** The RBI sets limits on the amount that can be borrowed through WMA, ensuring that the facility is used judiciously and aligns with fiscal prudence.

Purpose and Significance

- **Mitigating Short-Term Fiscal Strain:** WMA serves as a crucial tool for governments to navigate short-term fiscal challenges, allowing them to address immediate cash flow gaps promptly.
- **Ensuring Uninterrupted Operations:** By providing access to immediate funds, WMA ensures that essential government operations and services remain unaffected, even during periods of financial strain.
- **Balancing Fiscal Prudence:** The collaborative nature of WMA encourages a balanced approach to fiscal management, fostering transparency and accountability in financial dealings between the government and the RBI.
- **Emergency Financial Support:** WMA acts as a financial safety net, offering emergency support to governments facing unforeseen circumstances or financial emergencies, thereby contributing to overall fiscal stability.

CERTIFICATE OF DEPOSIT

The Certificate of Deposit (CoD) is an unsecured, negotiable money market instrument, akin to a promissory note, offering a guaranteed fixed return to the holder. Regulated by the Reserve Bank of India, this fixed-income financial instrument is electronically issued and maintained in a dematerialized form. Issuable by any financial institution or scheduled commercial bank in India, the Certificate of Deposit holds a value discounted from its face value, ensuring a predetermined payout to investors right from the outset.

Operating parallel to a fixed deposit account, the Certificate of Deposit provides documented proof that the investor has deposited funds with the bank for a specified period. The interest on this deposit is computed based on the amount and duration of the investment, assuring investors of a predetermined payout upon maturity.

Features of Certificate of Deposit

- They are fixed-income financial instruments that offer a fixed interest rate for a fixed period of time.
- They are issued by banks and financial institutions in India and regulated by the RBI.
- They have a minimum deposit amount of ₹ 1 lakh and a maturity period ranging from 7 days upto 1 years.
- They are transferable and tradable in the secondary market, but they cannot be used as collateral for loans.

Advantages of Certificate of Deposit

- **Security:** The guaranteed return and backing by financial institutions make CDs a secure investment, particularly attractive to risk-averse investors.
- **Predictable Returns:** With a fixed interest rate and guaranteed return, investors enjoy predictability in their financial outcomes, making CDs a valuable tool for financial planning.
- **Diversity in Maturity Options:** CDs offer a range of maturity options, allowing investors to align their investments with their specific financial goals and time horizons.

Limitations of Certificate of Deposit

- **Fixed term:** Investors cannot access their funds before maturity without penalties.
- **Inflation risk:** The fixed return may lose purchasing power due to rising inflation.
- **Limited return:** The return is lower than other investment options like stocks or mutual funds.
- **Non-transferable:** The investors cannot transfer the certificate to another party.
- **Penalty fees:** Withdrawing funds before maturity incurs fees that may reduce or eliminate the return.

- **Minimum investment:** The required amount may be too high for some investors.
- **Lack of diversification:** The investment does not offer the variety and balance of other financial instruments.

COMMERCIAL PAPER

Commercial Papers represent unsecured, short-term debt instruments issued by corporations, financial institutions, and sometimes even the government. These papers serve as a means for entities to raise quick and cost-effective short-term capital from the money market.

Features of Commercial Papers

- **Short-term maturity:** They are suitable for short-term financing needs.
- **Unsecured debt:** They do not have collateral and depend on the issuer's creditworthiness.
- **Cost-effective financing:** These have lower transaction costs and no intermediaries.
- **Flexibility in issuance:** Commercial papers can be issued in different denominations to suit the market demand.
- **Regulated by SEBI:** They are supervised by the securities regulator to ensure credibility.

Advantages of Commercial Paper

- **Cost-effective funding:** It offers lower interest rates than bank loans for temporary financing.
- **Enhanced liquidity:** It allows for quick and easy trading, ensuring funds availability.
- **Unrestricted access:** It does not have covenants or collateral, giving companies more flexibility and freedom.
- **Profitable investment:** It offers secure and reliable returns for low-risk investors.
- **Sustainable funding model:** It enables companies to create a self-funding cycle by issuing new paper to pay off old debt.

Limitations of Commercial Paper

- They are only available to financially sound and highly rated firms, as they do not have any collateral or guarantee.
- They have a limited amount of money that can be raised, depending on the liquidity and demand in the market.
- They are subject to interest rate risk, as the cost of borrowing may increase if the market rates rise.
- They are not regulated by any statutory authority, and hence there is no protection for the investors in case of default or fraud.
- They have a penalty for early redemption, which may reduce the return or cause a loss for the investors

COMMERCIAL BILLS

Commercial bills, a key instrument in short-term corporate finance, play a crucial role in facilitating transactions and addressing the immediate funding needs of businesses. A commercial bill, often referred to as a **trade bill** or **bill of exchange**, is a financial instrument that facilitates the transfer of funds between parties engaged in commercial transactions. It serves as a formal written order, directing the debtor to pay a specified amount to the creditor within a defined period.

Features of Commercial Bills

- Short-term instruments for trade financing.
- Two-party transactions between the seller and the buyer.
- Discounting facility for the seller to get funds in advance.
- Regulated by RBI for transparency and efficiency.

Significance of Commercial Bills

- **Trade facilitators:** They provide a payment mechanism and reduce cash flow uncertainties.
- **Short-term financiers:** They help businesses manage working capital and meet financial obligations.
- **Cash flow boosters:** They allow sellers to get funds in advance by discounting the bills.
- **Credit risk reducers:** They establish payment terms and a legal framework for transactions.

CAPITAL MARKET

The capital market stands as a cornerstone in the financial architecture, serving as a vital platform for businesses and investors alike. Capital markets represent a segment of the financial system where long-term securities, such as stocks and bonds, are bought and sold. It acts as a crucial intermediary connecting entities in need of capital with investors seeking avenues for investment.

The capital market is often divided into primary and secondary markets, each playing a distinct role in the life cycle of financial instruments.

Components of Capital Markets

- **Primary Market:** In the primary market, new securities are issued and sold for the first time. This process involves companies raising capital by issuing shares through Initial Public Offerings (IPOs) or governments issuing bonds. Investors purchase these newly issued securities, providing the issuer with fresh capital.
- **Secondary Market:** The secondary market facilitates the trading of existing securities among investors. Unlike the primary market, where securities are issued, the secondary market involves the buying and selling of previously issued securities. Stock exchanges, such as the BSE and NSE in India, provide platforms for secondary market transactions.

- **Equity Market:** The equity market, a subset of the capital market, deals with the buying and selling of company stocks. Investors become partial owners of the company through stock ownership, and trading occurs on stock exchanges.
- **Debt Market:** The debt market involves the buying and selling of fixed-income securities, such as bonds and debentures. These instruments represent loans given to the issuer by investors, with periodic interest payments and a return of principal at maturity.
- **Derivatives Market:** The derivatives market deals with financial contracts whose value is derived from an underlying asset, index, or rate. Common derivatives include futures and options, providing investors with tools for risk management and speculation.

Significance of Capital Markets

- **Capital Formation:** Capital markets play a pivotal role in facilitating capital formation by providing a platform for companies and governments to raise funds for expansion, projects, or infrastructure development.
- **Facilitating Investment:** Investors can deploy their capital in various financial instruments based on their risk appetite and investment objectives, contributing to a diversified and efficient allocation of funds.
- **Liquidity Enhancement:** The secondary market enhances liquidity, allowing investors to buy or sell securities easily. This liquidity is crucial for price discovery and efficient market functioning.
- **Economic Growth:** A robust capital market is closely linked to economic growth. By channelling funds to productive activities, capital markets foster innovation, job creation, and overall economic development.

PRIMARY MARKET VS SECONDARY MARKET

The capital market, a vibrant arena where financial instruments are bought and sold, comprises two essential segments: the primary market and the secondary market.

Primary Market

The primary market is where new securities make their debut, representing the initial issuance of financial instruments. Here, companies and governments directly interact with investors to raise fresh capital.

Features of the Primary Market

- **Initial Public Offerings (IPOs):** One of the primary mechanisms in the primary market is an IPO. Companies, seeking to go public, issue shares to the public for the first time, allowing investors to become stakeholders in the company.
- **New Debt Issuance:** Governments and corporations also utilise the primary market to issue new debt instruments, such as bonds and debentures, to raise funds for various projects and initiatives.
- **Pricing:** In the primary market, securities are typically offered at face value or a predetermined price. Investors subscribe to these issues, and the capital raised goes directly to the issuer.
- **Issuer-Investor Interaction:** The interaction in the primary market is direct between the issuer and the investor. Investors acquire securities directly from the issuing entity, fostering a connection between the company and its stakeholders.

Secondary Market

The secondary market, in contrast, is where existing securities, previously issued in the primary market, are bought and sold among investors.

Features of the Secondary Market

- **Stock Exchanges:** It operates through stock exchanges, providing a centralised platform for the buying and selling of securities. For example, New York Stock Exchange (NYSE), Bombay Stock Exchange (BSE), etc
- **Liquidity:** It allows Investors to easily buy or sell securities, based on the market forces of supply and demand.
- **Price Discovery**
  - Prices in the secondary market are not predetermined; instead, they are determined through continuous trading. This price discovery mechanism reflects the current market sentiment and information.
- **Role of Intermediaries**
  - Unlike the primary market, the secondary market involves intermediaries such as brokers and dealers who facilitate the trading process. Investors buy and sell securities through these intermediaries.

Comparison

	Primary Market/New Issue Market (NIM)	Secondary Market/Aftermarket
Nature of Transactions	Involves the issuance of new securities directly by the issuer to investors.	Investors trade previously issued securities among themselves without the involvement of the issuer of the securities.
Capital Flow	Capital flows from investors to the issuer.	Capital flows between investors; the issuer does not directly benefit
Pricing	Securities are priced at face value or a predetermined price.	Prices are determined by market forces and fluctuate based on supply and demand.
Issuer-Investor Relationship	Direct relationship between the issuer and investors.	No direct relationship between the issuer and subsequent investors.

IGNITE YOUR MIND

Considering the direct interaction between issuers and investors in the primary market and the role of intermediaries in the secondary market, do you think there should be a balance between direct access for companies to raise capital and the involvement of intermediaries to facilitate efficient trading in the secondary market?

FINANCIAL INSTRUMENTS IN CAPITAL MARKET

Financial instruments play a crucial role in the capital market, serving as vehicles for investors to participate in various asset classes and markets.

Financial Instruments in the Capital Market

Equities (Stocks)
- Represent ownership in a company.
- Traded on stock exchanges.
- Investors earn through capital appreciation and dividends.

Bonds
- Debt securities representing loans to entities.
- Pay periodic interest and return principal at maturity.
- Varying risk levels based on issuer creditworthiness.

Mutual Funds
- Pooled funds from multiple investors.
- Managed by professional fund managers.
- Diversification across assets for risk mitigation.

Debentures
- Corporate debt instruments representing a loan from investors to a company.
- Pay fixed interest and return principal at maturity.
- Rank higher than equity in the event of liquidation.

Participatory Notes (P-notes)
- Also known as PNs or P-Notes.
- Financial instruments used by foreign investors to invest in Indian securities without direct registration.
- Facilitate indirect investment in the Indian markets.

Exchange-Traded Funds (ETFs)
- Similar to mutual funds but traded on stock exchanges.
- Provide exposure to various assets or sectors.

Derivatives
- Financial contracts derived from an underlying asset.
- Include options and futures.
- Used for hedging, speculation, or leveraging.

Options
- Contracts granting the right to buy or sell assets at a predetermined price.
- Call options for buying, put options for selling.

Futures
- Agreements to buy or sell assets at a future date and price.
- Common in commodities, currencies, and financial indices.

Preferred Stocks
- Hybrid securities with characteristics of both stocks and bonds.
- Offer fixed dividends and priority over common shareholders.

Real Estate Investment Trusts (REITs)
- Allow investment in real estate without direct ownership.
- Trade on stock exchanges and provide dividends.

SOME MAJOR BONDS IN INDIA

Zero Coupon Bond

Zero Coupon Bonds, a distinctive class of fixed-income securities, deviate from conventional interest-bearing bonds, providing investors with a unique avenue for wealth accumulation.

Key Features

- **No Periodic Interest Payments**
  - Zero Coupon Bonds, as the name suggests, do not make periodic interest payments during their tenure.
  - Instead, they are issued at a discounted price and mature at their face value.
- **Issued at a Discount**
  - Investors acquire zero coupon bonds at a price significantly below their face value.
  - The difference between the purchase price and the face value represents the investor's return upon maturity.
- **Capital Appreciation**
  - The primary source of return for investors in zero coupon bonds is the capital appreciation realised when the bond matures.
  - This capital appreciation reflects the bond reaching its face value over time.

Advantages

- **Long-term wealth accumulation:** They offer a lump-sum return at maturity without regular interest income.
- **Risk mitigation:** They are less affected by interest rate changes due to their zero-coupon feature.
- **Diversification:** They diversify the portfolio with their unique payoff structure and complement other assets.
- **Tax implications:** They may incur taxes on the imputed interest, which requires tax planning.

Drawbacks

- **Lack of periodic income:** They do not pay interest until maturity, which may not suit income-seeking investors.
- **Interest rate risk:** They can lose market value if interest rates rise, affecting the present value and return.

Masala Bond

Masala bonds are rupee-denominated bonds issued outside India by Indian entities. They are debt instruments that help to raise money in local currency from foreign investors. Both the government and private entities can issue these bonds

Regulations by RBI

- **Eligibility**
  - Any corporate entity and Indian bank can issue Rupee-denominated bonds overseas.
- **Utilisation Restrictions**
  - Funds raised through Masala Bonds cannot be invested in real estate activities, but they can be used for integrated townships or affordable housing projects.
- **Capital Market Limitations**
  - Funds raised through Masala Bonds are not allowed to be invested in capital markets.

Facts about Masala Bond

- **Origin of the Term:** Coined by the International Finance Corporation (IFC), "Masala Bonds" derives its name from the Hindi word 'masala,' meaning spices, reflecting the infusion of Indian culture onto the global financial platform.
- **Pioneer Bond Issuance:** The inaugural Masala bond was launched by the IFC in 2014 to fund infrastructure projects in India.
- **Asian Development Bank Listing:** In February 2020, the Asian Development Bank listed 10-year Masala Bonds worth Rs 850 crore on India INX's global debt platform. This move aimed to bolster local currency and investments in India.
- **Cumulative Issuance Volume:** Reports indicate that as of 2020, Masala Bonds amounting to $5.5 billion equivalent had already been issued.
- **Comparable Foreign-Currency Bonds:** Similar to Masala Bonds, other foreign-currency-denominated bonds include Dim Sum Bonds (China) and Samurai Bonds (Japan).

Benefits of Masala Bonds

- They **reduce the exchange rate risk** for the borrowers, as they do not have to repay in foreign currency.
- They **diversify the sources of funding** for the issuers, as they can tap into the global market.
- They **increase the international visibility and demand for the Indian rupee**, as they promote its use in foreign markets.
- They **offer higher returns and tax benefits for the investors**, as they are exempt from capital gains tax and withholding tax in India.

Challenges of Masala Bond

- **Interest Rate Adjustments by RBI**
  - The periodic rate cuts implemented by the Reserve Bank of India (RBI) have somewhat diminished the attractiveness of Masala Bonds to investors.
- **Restricted Usage of Funds**
  - Funds raised through these bonds come with limitations on their utilisation.
  - Specific sectors or fields are earmarked where the raised capital can be invested.
- **Sustainability Concerns**
  - Moody's highlights concerns about the sustainability of financing through Masala Bonds. Investors are anticipated to exercise caution due to potential currency risks associated with emerging markets.

Green Bond

- **Overview**
  - SEBI defines green debt securities as instruments issued to raise funds for sustainable development or increased energy efficiency.
  - Explicit declaration of the cause for raising funds, often associated with "green" projects like renewable energy and pollution reduction.
- **Risk and Interest Rates**
  - Green bonds tend to have lower interest rates compared to commercial bank loans due to their linkage to the issuer rather than project success.
  - However, the lower risk can be a potential drawback if entities engage in **"greenwashing"** to collect funds under the guise of green bonds.
    - Presenting a company's goods, services, or business practices as more environmentally friendly than they truly are is termed **"greenwashing"**.
    - This deceptive practice misleads investors acquiring these securities or bonds and can also impact environmentally conscious consumers in their decision-making process.

SEBI Guidelines Addressing Greenwashing

SEBI has outlined guidelines to combat the issue of greenwashing in the context of green bonds

Prohibition of Misleading Practices

- Issuers are not allowed to highlight positive green activities while concealing unfavourable ones through misleading labelling, hiding trade-offs, or selectively presenting facts from research.
- Issuers are encouraged to closely monitor the transition to a more sustainable mode of operation.

Responsible Utilisation of Funds

- The circular emphasises that funds raised through green bonds must be used for purposes qualifying as "green debt securities" under the non-convertible securities (NCS) regulations.
- Issuers must maintain alignment with the assigned grade for the green debt product and uphold the highest standards in its issuance.

Quantification of Harmful Externalities

- The guidelines mandate the quantification of harmful externalities associated with the utilisation of funds generated through green debt securities.
- Misleading representations implying certification by a third party are strictly prohibited under these guidelines.

- **Nature of Green Bonds**
  - Function as debt instruments similar to traditional bonds.
  - Capital raised is dedicated to projects with positive environmental impacts.
- **Issuers and Allocation**
  - Governments and private entities, including multinational corporations, can issue green bonds.
  - Funds from green bonds are earmarked exclusively for environmentally sustainable projects, distinguishing them from regular bonds.
- **Project-Specific Details**
  - Issuers of green bonds must provide detailed information about the project requiring green financing.
  - The overall environmental benefits resulting from the funded project must be outlined.
- **Sovereign Green Bonds in India**
  - As part of its borrowing program, the Indian government introduced sovereign green bonds in November 2022.
  - Proceeds from sovereign green bonds will finance or refinance projects promoting renewable energy, clean transportation, energy efficiency, climate change adaptation, sustainable water and waste management, pollution prevention, and green buildings.

Benefits of Green Bond

- Encourages environmentally responsible practices by making high carbon-emitting projects less attractive.
- Acts as a hedge against risks related to environmental degradation and climate change.
- Provides a return on investments in sustainable and eco-friendly initiatives.
- Sovereign green bonds support India in raising funds to address climate change challenges.
- Assists in adapting to environmental issues and achieving goals outlined in Intended Nationally Determined Contributions (INDC).

Latest Developments in Green Bonds

- REC Limited, a government-owned Maharatna power finance company, has listed its green bonds exclusively on the GIFT IFSC stock exchanges in Gandhinagar, Gujarat.
- These green bonds, with a total worth of $750 million, were raised under REC's $7-billion global medium-term program.
- This issuance marks a significant milestone, being the first instance of an Indian company issuing green bonds after India assumed the G20 presidency. Moreover, it stands as the largest USD tranche issued by an Indian non-banking financial company (NBFC).

Social Impact Bond

- Social Impact Bonds (SIBs), also known as **Pay-for-Success Bonds**, leverage private sector investments for positive social outcomes.
- SIBs involve collaboration between government agencies, social service providers, and private investors.
- Government agencies identify specific social problems, like reducing homelessness or improving education, to address.
- Private investors, including individuals, philanthropic organisations, or impact investors, provide upfront capital through a **Special Purpose Vehicle (SPV)** or intermediary.
- Social Impact Bonds are considered high-risk investments due to their dependence on achieving intended social consequences.

Benefits of Social Impact Bond

- **Innovation:** SIBs stimulate innovative approaches to addressing social issues by shifting the focus from funding programs (inputs) to achieving measurable impact (outcomes).
- **Efficiency:** They incentivize the effective use of resources by linking payments to the accomplishment of specific outcomes.
- **Risk Transfer:** SIBs shift financial risk from the government to private investors, alleviating the fiscal burden on taxpayers.

- **Accountability:** SIBs highlight accountability and data-driven decision-making, as success relies on achieving measurable outcomes.
- **Collaboration:** They encourage collaboration among government, service providers, and investors, fostering partnerships to address complex social challenges.

Challenges of Social Impact Bond

- Complexity
- Structuring and administering SIBs can be intricate, involving numerous stakeholders and detailed outcome measurement.

- **Costs:** The setup and administrative expenses of SIBs can be substantial, and investors may demand a significant return on investment.
- **Outcome Measurement**: Defining clear and measurable outcomes can pose challenges for certain social issues.
- **Selection Bias:** There is a risk of favouring interventions more likely to succeed, potentially excluding innovative but riskier approaches.
- **Scale:** SIBs may not be applicable to all types of social problems, and scalability can be limited.

Difference between Social Impact Bond and Conventional Bond

Difference	Social Impact Bond	Conventional Bond
Purpose	Social Impact Bonds are designed to address social or environmental challenges. They fund specific social programs or interventions to achieve measurable, positive outcomes in areas like education, healthcare, or criminal justice. Social Impact Bonds deliver both financial returns and social impact.	Conventional bonds are issued for various purposes, such as funding infrastructure projects, covering operational expenses, or refinancing existing debt. They aim to generate financial returns for investors.
Investor	Social Impact Bonds attract impact investors and philanthropic organisations interested in generating financial returns and social or environmental benefits. Returns in Social Impact Bonds are tied to the achievement of predetermined social outcomes.	Conventional bonds attract a wide range of investors, including individuals, institutions, and financial organisations. Returns come from periodic interest payments and the principal investment at maturity.
Risk and Returns	Social Impact Bonds tie financial returns to specific social outcomes. Investors may receive higher returns if outcomes are achieved and lower returns or none if outcomes are unmet. Risk is linked to the success of the social program.	Conventional bonds offer fixed or variable interest rates. Returns are primarily based on interest payments, and risk is related to the issuer's creditworthiness and the possibility of default.
Performance	Social Impact Bonds are explicitly designed for impact measurement, with predetermined metrics and targets. Independent evaluators assess outcomes, and investor returns depend on program success.	Performance of conventional bonds is assessed in financial terms, such as yield to maturity, credit rating, and coupon payments. There is no direct measurement of social or environmental impact.
Uses	Proceeds from Social Impact Bonds are earmarked for specific social programs or interventions, focusing on addressing social challenges, improving well-being, or achieving environmental goals.	Proceeds from conventional bonds can be used for various purposes determined by the issuer, from general operational needs to capital projects or debt refinancing.
Government's Role	Governments frequently assume a pivotal role in Social Impact Bonds, acting as payors or outcome funders. They pledge to compensate investors based on the attainment of social goals, thereby establishing Social Impact Bonds as a manifestation of public-private partnership.	Governments might issue traditional bonds to finance public projects or operations, but these bonds are not explicitly linked to the accomplishment of social outcomes

Inflation Indexed Bond

Inflation Indexed Bonds, also known as inflation-linked bonds, emerge as financial instruments designed to navigate the challenges posed by inflation.

Key Features

- **Inflation Protection**
  - Inflation Index Bonds are structured to shield investors from the erosive effects of inflation.
  - Unlike traditional bonds, the principal value of these bonds is adjusted periodically based on changes in an inflation index.
- **Link to Consumer Price Index (CPI)**
  - The most common mechanism involves linking the bond's value to a specific inflation index, often the Consumer Price Index (CPI).
  - As the CPI rises or falls, the principal value of the bond adjusts accordingly.
- **Coupon Payments and Maturity**
  - Unlike traditional bonds, Inflation Index Bonds may have variable coupon payments.
  - The principal, when redeemed at maturity, reflects adjustments for inflation, ensuring investors receive returns that outpace the inflation rate.

Advantages

- **Preservation of Purchasing Power**
  - Inflation erodes the purchasing power of money over time. Inflation Index Bonds aim to counteract this effect.
  - Investors can expect their investment to maintain its real value, adjusting for changes in the cost of living.
- **Predictable Returns**
  - The link to a recognized inflation index provides investors with a degree of predictability.
  - Returns on Inflation Index Bonds are tied to changes in the cost of living, offering transparency for investors.
- **Diversification Strategy**
  - Including Inflation Index Bonds in a diversified portfolio can be a strategic move.
  - These bonds can act as a hedge, providing stability when inflation rates fluctuate.

Drawbacks

- **Interest Rate Risk**
  - Inflation Index Bonds may still be exposed to interest rate risk.
  - Changes in interest rates can impact bond prices, influencing the overall return on investment.
- **Tax Implications**
  - Investors should consider the tax implications associated with Inflation Index Bonds.
  - Understanding how taxation affects returns is crucial for effective financial planning.
- **Economic Conditions**
  - Economic conditions and inflation trends play a vital role in the performance of these bonds.
  - Investors should stay informed about macroeconomic factors influencing inflation.

Municipal Bond

A municipal bond is a debt security issued by a Local Government entity to fund projects, promising interest and principal repayment on a specified date. Its appeal lies in tax exemptions, particularly advantageous for high-income individuals

Significance of Municipal Bonds

Municipal Bonds can help Urban Local Bodies (ULBs) garner revenue for budgetary projects, crucial as property tax is a major municipal revenue source. The growth of the municipal bond market is vital for India's cities and towns to upgrade infrastructure, supporting initiatives like Smart Cities and Amrut.

History of Municipal Bonds Issuance in India

Municipal bonds were first introduced in India in 1997, five years after the 74th Constitutional Amendment decentralised urban local bodies. These reforms made them accountable, autonomous, and enabled them to access capital markets.

Between 1997 and 2010, Bengaluru, Ahmedabad, and Nashik experimented with bond issues but struggled to raise funds.

SEBI's guidelines in March 2015 clarified regulatory status, making municipal bonds tradable and safer for investors.

In 2017, Pune Municipal Corporation raised Rs. 200 crore for its 24x7 water supply project at an interest of 7.59%.

Advantages of Municipal Bonds

- **Transparency:** Publicly issued municipal bonds are rated by agencies like CRISIL, providing investors transparency about the investment's credibility.
- **Tax Benefits:** In India, municipal bonds are tax-exempt under specific rules. Interest rates on such investments are also tax-free.
- **Minimal Risk:** Issued by municipal authorities, municipal bonds involve minimal risk, as government bonds are generally considered low-risk investments.

Drawbacks

- **Reduced Investor Trust:** Weak financial positions, poor governance, and management have limited the ability of city agencies to issue bonds, reducing investor trust.
- **Lack of Authentic Financial Data:** Investors doubt local bodies due to the absence of authentic financial data.
- **Other Issues:** Low accountability, autonomy, and an enabling environment for city agencies are challenges.

Way Forward

- **Covid-19 Impact:** The pandemic has halted revenue generation and state finances, emphasising the need for funding ULBs.
- **Atmanirbhar Bharat Abhiyan:** The Atma Nirbhar Bharat Abhiyan offers increased borrowing capacity for states

linked to potential reforms in the urban property tax regime.

- **Reforms:** Reforms outlined in the 15th Finance Commission, mandating audited accounts for grant disbursement, need implementation for transparency, creditworthiness, and ULBs' ability to float Municipal bonds.

Sovereign Gold Bond Scheme

The Sovereign Gold Bond (SGB) Scheme, introduced by the Government of India, provides investors with an innovative and secure avenue to invest in gold. Launched in 2015, the scheme aims to reduce the country's reliance on physical gold imports, promote financial savings, and channel funds for productive purposes.

Key Features

- **Government-Backed Security:** SGBs are issued by the Reserve Bank of India (RBI) on behalf of the Government of India, making them a sovereign-backed investment.
- **Denomination:** Investors can purchase SGBs in multiples of one gram of gold, allowing flexibility based on individual investment capacities.
- **Interest Income:** SGBs offer an annual interest rate, providing an additional income stream. The interest is credited semi-annually to the investor's bank account.
- **Maturity Period:** The maturity period of SGBs is eight years, with an exit option available from the fifth year onwards. Additionally, they can be used as collateral for loans.
- **Tax Benefits:** SGBs provide capital gains tax exemptions on redemption if held until maturity. However, if sold before maturity, capital gains tax applies.
- **Gold Price Indexation:** The redemption amount is linked to the prevailing gold prices, ensuring investors benefit from increases in gold values.

Advantages of SGBs

- **Safe and Secure:** Backed by the government, SGBs offer a secure investment option compared to physical gold.
- **No Storage Hassles:** Investors are relieved of the burden of safe storage and insurance costs associated with physical gold.
- **Interest Earnings:** The additional interest income makes SGBs more attractive than holding physical gold.
- **Capital Appreciation:** As the redemption value is linked to gold prices, investors can benefit from capital appreciation.

Challenges and Considerations

- **Liquidity:** While SGBs offer liquidity through stock exchanges, they might not match the ease of selling physical gold.
- **Fixed Maturity:** The eight-year lock-in period may limit liquidity for investors with short-term goals.
- **Market Fluctuations:** The market value of SGBs can fluctuate based on gold prices, impacting the redemption amount.

IGNITE YOUR MIND

Do you think the introduction of Sovereign Green Bonds in India reflects a positive step towards aligning financial investments with sustainable and environmentally responsible projects?

MUTUAL FUNDS

Mutual funds have emerged as a popular investment vehicle, offering individuals an opportunity to participate in diverse financial markets with the guidance of professional fund managers. This collective investment scheme pools funds from numerous investors to create a diversified portfolio of stocks, bonds, or other securities.

Key Components

- **Investors:** Individuals, known as unitholders, contribute money to the mutual fund, becoming indirect owners of the fund's portfolio.
- **Fund Manager:** A skilled fund manager is appointed to make investment decisions based on the fund's objectives and market conditions.
- **Portfolio:** The mutual fund accumulates a diversified portfolio of various assets such as stocks, bonds, or a mix of both, depending on its investment mandate.
- **Units:** Investors receive units in proportion to their investment, representing their share in the fund's holdings.

Types of Mutual Funds

- **Equity Funds:** Invest primarily in stocks, offering potentially high returns but accompanied by higher volatility.
- **Debt Funds:** Primarily invest in fixed-income securities like bonds and treasury bills, offering stable returns with lower risk.
- **Hybrid or Balanced Funds:** Combine both equity and debt instruments to balance risk and return.
- **Index Funds:** Mirror a specific market index, providing returns similar to the index they track.
- **Sectoral Funds:** Concentrate investments in specific sectors like technology, healthcare, or energy.

Advantages of Mutual Funds

- **Diversification:** Mutual funds spread investments across various assets, reducing risk compared to investing in individual securities.

- **Professional Management:** Experienced fund managers conduct in-depth research and make informed investment decisions.
- **Liquidity:** Mutual fund units can be easily bought or sold, providing liquidity to investors.
- **Affordability:** Investors can participate with relatively small amounts, allowing access to a diversified portfolio.
- **Transparency:** Regular reporting and disclosure of fund performance ensure transparency for investors.

Drawbacks of Mutual Funds

- **Risk Profile:** Choosing a fund aligned with one's risk tolerance and financial goals is crucial.
- **Costs and Fees:** Investors should be aware of the fees associated with mutual funds, including expense ratios and front-end or back-end loads.
- **Performance Track Record:** Assessing the historical performance of a fund and understanding its investment strategy is essential.
- **Exit Load:** Some funds charge exit loads for redemptions made before a specified period.

DERIVATIVES

Derivatives are contracts between two parties, deriving their price/value from an underlying asset like futures, options, forwards, and swaps. The fluctuating values of derivatives are directly influenced by changes in the underlying asset, for instance, a derivative linked to gold responding to gold price variations.

Forwards

A forward contract is a type of derivative that allows two parties to agree on buying or selling an asset at a fixed price on a future date. It can be used for hedging or speculation, but it is not standardised or traded on an exchange.

Some examples of forward contracts are:

- A farmer who wants to lock in the price of their crop before harvest
- A manufacturer who wants to secure the cost of their raw materials in advance
- A currency trader who wants to exploit the difference between the spot and forward exchange rates.

Key Features

- **Bespoke Agreements:** Unlike standardised exchange-traded contracts, forwards are customised agreements between two parties, offering flexibility in terms of the underlying asset, price, and date.
- **Over-the-Counter:** Forwards are not traded on central exchanges, but rather negotiated directly between the parties involved, leading to less regulation and transparency.
- **Hedging Tool:** Forwards are primarily used for hedging risk, allowing businesses and individuals to lock in a future price for an asset and protect themselves against market fluctuations.
- **Counterparty Risk:** As forwards are not standardised and involve direct counterparty agreements, there is a risk that one party may default on their obligation, potentially leading to losses for the other party.

Pros

- **Flexibility:** Forwards offer greater flexibility than standardised contracts, allowing for customization to specific needs and risk profiles.
- **Risk Mitigation:** Forwards can be a valuable tool for hedging risk and protecting against market volatility.
- **Tailored Solutions:** The bespoke nature of forwards allows for the creation of contracts that precisely address specific risk management needs.

Cons

- **Counterparty Risk:** The lack of regulation and reliance on direct counterparty agreements can expose parties to the risk of default.
- **Lack of Transparency:** Over-the-counter transactions are less transparent than exchange-traded contracts, making it more difficult to assess risks and pricing.
- **Not a Guarantee of Profit:** While forwards can help mitigate risk, they do not guarantee profits and are still subject to the performance of the underlying asset.

Futures

- Futures, like their over-the-counter cousin forwards, offer a peek into the future. However, unlike forwards, they waltz across standardised and regulated exchange floors, bringing transparency and ease of trading. This standardisation makes them a popular choice for commodity speculation, where seasoned investors and speculators can navigate the volatile seas of market movements.
- But futures are not without their limitations. **In December 2021, the Securities and Exchange Board of India (SEBI) curtailed futures trading in seven key agricultural commodities, including soybean, crude palm oil, wheat, and rice.** This move aimed to curb excessive speculation and protect farmers from price manipulation in these essential food items.

Differences Between Forwards and Futures

- **Trading Venue:** Forwards are negotiated privately, while futures are traded on exchanges.
- **Standardisation:** Forwards are customised agreements, while futures adhere to standardised contracts.
- **Regulation:** Forwards have less regulatory oversight, while futures are subject to exchange rules and SEBI regulations.

- **Accessibility:** Forwards are typically accessible to institutional investors, while futures are generally more accessible to individual investors.

Options

Key Features

- **Flexibility:** Unlike forwards and futures, options offer the right, not the obligation, to buy or sell an asset at a specific price in the future, providing flexibility and the ability to adapt to market movements.
- **No Commitment:** Parties are not legally bound to exercise their options, allowing them to walk away if the market moves unfavourably.
- **Risk Mitigation:** Options can be used to hedge existing positions, minimising potential losses if the market takes a downturn.
- **Speculation:** Options offer opportunities for calculated risk-taking, allowing investors to amplify potential gains while limiting losses compared to directly buying or selling the underlying asset.

Advantages

- **Flexibility:** Options allow you to choose whether or not to exercise your right, providing freedom and adaptability based on market conditions.
- **Risk Management:** Options can be used to hedge existing positions, mitigating potential losses in volatile markets.
- **Leverage:** Options offer leverage, allowing you to control larger positions with smaller upfront investments compared to directly buying or selling the underlying asset.

Disadvantages

- **Cost:** Options come with a premium, which can reduce potential profits and increase losses if the option is not exercised.
- **Complexity:** Understanding option pricing, market dynamics, and the intricacies of different types of options requires careful study and due diligence.
- **Risk of Loss:** Options are inherently risky, and the potential for losses can be significant, especially for inexperienced investors.

Swaps

Key Feature

- **Cash Flow Exchange:** Swaps are financial agreements where parties exchange one type of cash flow (e.g., interest rate, currency) for another, often over-the-counter (OTC) rather than on exchanges.
- **Risk Management:** Swaps can be used to hedge existing positions or manage exposure to specific risks like interest rate fluctuations or currency volatility.
- **Tailored Solutions:** The flexibility of OTC agreements allows for customised swaps to address specific financial needs and risk profiles.
- **Liquidity Enhancement:** Swaps can improve liquidity for certain asset classes or market segments.

Types of Swaps

- **Interest Rate Swaps**
  - **Fixed for Variable:** Convert a variable-rate loan to a fixed-rate one for predictable cash flow and risk management.
  - **Variable for Fixed:** Secure access to variable rates for potential gains, while mitigating downside risk with a fixed-rate component.
- **Currency Swaps**
  - **Streamline Operations:** Simplify international business by swapping cash flows in different currencies, reducing transaction costs and exchange rate exposure.
  - **Hedging Strategies:** Protect against currency fluctuations by entering into swap agreements that offset potential losses.

Advantages of Swaps

- **Risk Management:** Hedging existing positions and mitigating exposure to specific risks like interest rates or currency fluctuations.
- **Tailored Solutions:** Flexibility to customise swap agreements to address specific financial needs and risk profiles.
- **Liquidity Enhancement:** Improve liquidity in certain asset classes or market segments through swap agreements.

Drawbacks of Swaps

- **Counterparty Risk:** Reliance on private agreements introduces the risk of one party defaulting on their obligations.
- **Complexity:** Understanding swap agreements and their risks requires significant financial expertise.
- **Lack of Transparency:** Over-the-counter nature makes tracking pricing and assessing market risks more difficult.

ALTERNATIVE INVESTMENT FUNDS (AIFS)

- Pools of capital targeting diverse, often illiquid assets like private equity, real estate, hedge funds, and infrastructure projects.
- Offer flexibility and customization, catering to a range of risk profiles and investment goals.
- Not subject to the same regulations as traditional mutual funds, allowing them to pursue more diverse and potentially risky strategies

Regulatory Framework

- The regulatory framework for AIFs is provided by the Securities and Exchange Board of India (SEBI). SEBI classifies AIFs into three categories based on their

investment strategies and objectives – Category I, Category II, and Category III.

- Each category has distinct risk profiles and regulatory requirements.

Key Characteristics

- **Closed-End Structure:** AIFs typically have a fixed tenure, providing investors with limited redemption options during the fund's life.
- **Sophisticated Investors:** AIFs attract high-net-worth individuals and institutional investors due to their specialised nature and risk-return profiles.
- **Professional Fund Managers:** Managed by experienced fund managers who employ diverse strategies to achieve the fund's objectives.

Benefits For Investors

- **Diversification:** AIFs offer diversification beyond traditional asset classes, reducing overall portfolio risk.
- **Access to Niche Markets:** Investors can gain exposure to niche markets, such as startups or distressed assets, which might not be accessible through conventional investments.
- **Potential for Higher Returns:** AIFs, particularly in Categories II and III, have the potential for higher returns compared to traditional investments.

Challenges and Considerations

- **Complexity:** The intricate strategies employed by some AIFs may pose challenges for retail investors, necessitating a thorough understanding.
- **Liquidity Risks:** Closed-end structures may limit liquidity, and investors should be prepared for longer investment horizons.
- **Regulatory Changes:** AIFs operate within a regulatory framework that may evolve, impacting their structure and operations.

Environmental, Social, and Governance (ESG) Funds

ESG funds represent a transformative approach to investing that goes beyond traditional financial metrics. These funds consider environmental, social, and governance factors to assess a company's sustainability and ethical practices. Investors increasingly turn to ESG funds to align their financial goals with social and environmental responsibility.

ESG Criteria

- **Environmental Factors:** Evaluate a company's impact on the environment, including its carbon footprint, resource usage, and commitment to sustainable practices.
- **Social Factors:** Examine how a company manages relationships with employees, communities, and its overall societal impact.
- **Governance Factors:** Assess the quality of a company's leadership, board structure, executive compensation, and adherence to ethical business practices.

Driving Forces Behind ESG Investments

- **Global Sustainability Concerns:** Growing awareness of climate change, social inequality, and ethical business practices has fueled interest in investments that address these concerns.
- **Millennial Preferences:** Younger investors often prioritise investments aligned with their values, driving the surge in demand for ESG funds.
- **Risk Mitigation:** ESG criteria provide a comprehensive risk assessment, helping investors identify companies better positioned for long-term success.

Performance of ESG Funds

- **Financial Performance:** Studies suggest that ESG-focused companies may exhibit stronger financial performance over the long term, dispelling the myth that sustainability comes at the expense of returns.
- **Risk Management:** ESG factors contribute to risk mitigation by identifying companies better equipped to navigate environmental and social challenges.

Types of ESG Funds

- **ESG Integration Funds:** Incorporate ESG factors into traditional financial analysis.
- **Exclusionary Screening Funds**
  - Exclude companies involved in controversial activities, such as weapons production or environmental degradation.
- **Impact Investing:** Aims to generate positive social or environmental outcomes alongside financial returns.

The Indian Context

- **Rising ESG Awareness:** India has witnessed a surge in ESG awareness, with companies and investors recognizing the importance of sustainable practices.
- **Regulatory Push:** Regulatory bodies are encouraging ESG disclosures and integrating sustainability reporting into corporate governance norms.

Challenges in ESG Investing

- **Lack of Standardization:** ESG metrics lack standardisation, making it challenging for investors to compare and assess different funds consistently.
- **Greenwashing:** Some critics argue that certain companies may exaggerate their ESG efforts to attract investment without implementing substantial changes.
- **Limited Historical Data:** ESG investing is a relatively recent phenomenon, resulting in limited historical data for performance analysis.

Regulatory Landscape

- **Increasing Regulations:** Governments and financial regulators are recognizing the importance of ESG considerations, leading to the development of regulatory frameworks and reporting requirements.

Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) have emerged as significant players in the global financial landscape, representing a form of state-owned investment pools. This article delves into the characteristics, objectives, and impact of Sovereign Wealth Funds, elucidating their role in safeguarding and enhancing a nation's wealth.

Objectives and Functions of SWFs

- SWFs can act as a **buffer against future economic downturns**, ensuring resources for future generations.
- Funds can be directed towards infrastructure projects, education, or technological advancements, bolstering national growth.
- SWFs can **mitigate the impact of volatile resource prices** by diversifying investments and generating **alternative income streams**.
- **Strategic investments** by SWFs can strengthen a country's global presence and influence.
- SWFs aim to safeguard and grow a nation's wealth, **ensuring long-term financial sustainability.**

Funding Sources

- SWFs, especially prevalent in oil-rich nations, derive funding from **revenues generated by commodities.**
- Countries with substantial **foreign exchange reserves** allocate portions to SWFs, enhancing returns.

Key Sovereign Wealth Funds

- **Norway's Government Pension Fund Globa:** One of the world's largest SWFs, notable for transparency and ethical investment practices.
- **Abu Dhabi Investment Authority (ADIA):** Originating from oil wealth, ADIA is a major global SWF with diversified investment portfolios.

Challenges and Criticisms

- **Lack of Transparency:** Some SWFs face scrutiny for perceived lack of transparency and potential political influence.
- **Political Considerations:** Criticisms often revolve around concerns regarding political motives and decision-making within SWFs.

Governance and Regulations

- **Santiago Principles:** Many SWFs adhere to the Santiago Principles, a set of best practices emphasising transparency, governance, and accountability.
- **National Regulatory Frameworks:** Nations establish regulatory frameworks to govern SWF operations, ensuring responsible investment practices.

Future Trends and Evolving Landscape

- **ESG Integration:** SWFs increasingly incorporate Environmental, Social, and Governance (ESG) criteria into investment decisions.
- **Technology and Innovation:** SWFs explore opportunities in technology sectors, renewables, and innovative industries to adapt to evolving economic landscapes.

National Investment and Infrastructure Fund (NIIF)

Established by the Government of India, the National Investment and Infrastructure Fund (NIIF) stands as the country's inaugural sovereign wealth fund. This overview introduces NIIF, touches upon its conceptual framework, and provides insights into its objectives, types, and investors.

Key Details

- The idea for NIIF was presented in the Union Budget 2015-2016 by the former Finance Minister, Arun Jaitley.
- Approval granted by the Department of Economic Affairs in August 2015.
- **Headquarters:** Mumbai, Maharashtra, India
- **Government Ministry:** Ministry of Finance
- **Types of Projects Supported:** Greenfield Projects & Brownfield Projects

Objectives of NIIF

National Investment and Infrastructure Fund (NIIF) operates as a sovereign wealth fund and holds registration with the Securities and Exchange Board of India (SEBI) as a Category II Alternate Investment Fund (AIF) under SEBI Regulations, 2012.

The **primary objectives of NIIF** include:

- **Long-Term Capital for Infrastructure Projects:** NIIF aims to provide long-term capital for projects related to infrastructure development.
- **Fundraising Through Various Instruments:** NIIF endeavours to raise funds through a variety of instruments, including offshore credit-enhanced bonds.
- **Anchor Investor Participation:** The fund seeks to attract anchor investors to participate as partners in NIIF.
- **Investor Servicing:** NIIF is committed to servicing the investors associated with the fund.
- **Approval of Investments:** One of its key functions is to assess and approve potential companies, institutions, and projects for investments.
- **Investment in Private Equity:** NIIF is empowered to invest in the corpus created by Asset Management Companies (AMCs) for private equity investments.
- **Advisory Services and Project Preparation:** NIIF provides advisory services and undertakes the preparation of a project shelf in the infrastructure sector.

Types of NIIF Funds

The National Investment and Infrastructure Fund (NIIF) oversees **three distinct funds**, each designed to serve specific investment purposes. These funds, established to channel capital from both domestic and international investors into infrastructure-related projects, are as follows:

- **Master Fund**
  - **Objective:** The Master Fund focuses on investing in well-established enterprises with long-term agreements, operating in regulated environments with a robust track record.
  - **Investment Strategy:** This fund also directs investments into infrastructure-related projects and adopts a strategy of establishing sector-specific companies in collaboration with prominent enterprises.
- **Fund of Funds**
  - **Objective:** The Fund of Funds aims to invest in funds managed by reputable fund managers with a proven track record.
  - **Investment Approach**
    - Additionally, it serves as an anchor investor, enabling fund managers to attract more funds from institutional investors.
    - Fund of Funds may also engage in joint ventures with fund managers.
- **Strategic Fund**
  - **Objective:** The Strategic Fund primarily focuses on investments in equity and equity-linked instruments.
  - **Regulatory Status:** Registered as an Alternative Fund II under the Securities and Exchange Board of India (SEBI).

Investors of National Investment and Infrastructure Fund (NIIF) & Its Key Developments

- In October 2017, NIIF secured its first investment deal worth USD 1 billion with the Abu Dhabi Investment Authority (ADIA), marking ADIA as the first international investor in NIIF's master fund.
- The Indian Government holds a 49% share in the National Investment and Infrastructure Fund.
- Domestic investors include HDFC Bank, Axis Bank, ICICI Bank, and Kotak Mahindra Life.
- In June 2018, the Asian Infrastructure Investment Bank announced a USD 200 million investment in NIIF, with an initial USD 100 million investment and a commitment to an additional USD 100 million at a later date.
- NIIF manages over $4.3 billion of equity capital commitments across three funds: Master Fund, Fund of Funds, and Strategic Opportunities Fund.
- The Strategic Opportunities Fund directly invests in companies, supporting ventures like FirstCry and Ather Energy.
- The Master Fund focuses on businesses and assets in core infrastructure sectors, ranking as one of the largest India-focused infrastructure funds.
- NIIF plans to launch its first InvIT for road assets, estimating a portfolio value of about $2 billion.

Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)

Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) are transforming the investment landscape, offering unique opportunities for investors to tap into real estate and infrastructure assets.

Real Estate Investment Trusts (REITs)

Real estate investment trusts (REITs) are companies that own, operate, or finance income-producing real estate. They allow investors to earn dividends from real estate investments without having to buy or manage any properties themselves.

- **Focus:** Generate income through owning and operating income-producing real estate assets like offices, malls, hotels, and warehouses.
- **Investment Landscape:** Primarily traded on stock exchanges, providing liquidity and transparency.
- **Returns:** Distribute a significant portion of income (minimum of 90%) to investors as dividends, ensuring a steady income stream.
- **Benefits:** Offer diversification, access to professionally managed real estate portfolios, and potentially higher returns compared to traditional investments.

Infrastructure Investment Trusts (InvITs)

Infrastructure Investment Trusts (InvITs) are a type of investment vehicle that allows investors to participate in the income and growth of infrastructure projects. They are similar to mutual funds, but they focus on infrastructure assets such as roads, power plants, telecom towers, etc.

- **Focus:** Invest in infrastructure projects like roads, bridges, power plants, and renewable energy assets.
- **Investment Landscape:** Typically not listed on stock exchanges, offering limited liquidity but potentially higher yields.
- **Returns:** Distribute a major portion of income (minimum of 90%) to investors through regular payouts, providing a stable income stream.
- **Benefits:** Provide exposure to critical infrastructure, contribute to national development, and offer attractive fixed-income returns.

Features of REITs and InvITs

- **Dividend Distribution:** Both REITs and InvITs are mandated to distribute a significant portion of their income as dividends.
- **Liquidity:** Units of REITs and InvITs are traded on stock exchanges, providing investors with liquidity and easy entry/exit options.

Benefits to Investors

- **Diversification:** Investors gain exposure to real estate and infrastructure assets without direct ownership, promoting portfolio diversification.
- **Regular Income:** Stable returns from rental income and cash flows contribute to a consistent income stream for investors.

Recent Trends

While fundraising via REITs and InvITs in FY23 has hit an all-time low, several factors contribute to this decline:

- **Global Economic Uncertainty:** Rising interest rates and inflation dampen investor sentiment, making them cautious about committing capital to long-term investments.
- **Regulatory Concerns:** Ongoing discussions on potential regulatory changes in the InvIT space create uncertainty among investors, leading to a wait-and-see approach.
- **Project Pipeline:** Limited availability of high-quality, investable projects in both sectors impacts fundraising activity.

Challenges and Regulatory Framework

- **Market Volatility:** Market fluctuations and economic uncertainties can affect the performance of REITs and InvITs.
- **Regulatory Compliance:** SEBI outlines regulatory frameworks, ensuring investor protection and market integrity.

Role in Economic Development

- **Infrastructure Growth:** InvITs contribute to the growth of crucial infrastructure projects, aiding economic development.
- **Real Estate Sector Boost:** REITs play a pivotal role in boosting the real estate sector by facilitating liquidity and enhancing investor confidence.

Way Forward

Despite the current dip, the long-term outlook for REITs and InvITs remains positive, driven by:

- **Urbanisation and Infrastructure Development:** The growing demand for real estate and modern infrastructure across India supports the growth of REITs and InvITs.
- **Government Initiatives:** Supportive government policies and initiatives aimed at boosting the real estate and infrastructure sectors provide further impetus.
- **Diversification Opportunities:** REITs and InvITs offer investors diversification benefits and the potential for attractive returns, making them increasingly appealing in the long run.

Exchange Traded Fund

- ETFs, or Exchange Traded Funds, are mutual funds that are listed and traded on stock exchanges similarly to individual shares.
- Index ETFs are established by institutional investors exchanging shares in an index basket for units in the fund.
- Typically, ETFs operate as passive funds, meaning the fund manager doesn't actively choose stocks on behalf of investors. Instead, the ETF mirrors an index, aiming to replicate its performance accurately.
- In an ETF, investors can buy and sell units at the current market price in real-time during market hours.

Types of Exchange-Traded Funds

Diverse ETFs offer investors avenues for income, speculation, risk management, and more.

Here's a nuanced look at various types:

- **Passive and Active ETFs**
  - Passive ETFs mirror indices or sectors, like gold mining stocks, providing broad market exposure.
  - Active ETFs involve managerial decisions, potentially outperforming passive counterparts but often at a higher cost.
- **Bond ETFs**
  - These focus on generating regular income, and tracking underlying bond performance.
  - These include government, corporate, and municipal bonds without a set maturity date, trading at premiums or discounts.
- **Stock ETFs:** Comprising a basket of stocks, they track specific industries or sectors, offering diversified exposure and lower fees compared to traditional mutual funds.
- **Industry/Sector ETFs:** Aimed at specific sectors or industries, providing targeted exposure to sector performance while mitigating individual stock volatility.
- **Commodity ETFs:** Invest in commodities like crude oil or gold, offering diversification benefits and cost-effectiveness compared to physical commodity possession.
- **Currency ETFs:** Track currency pairs, serving purposes like speculation, portfolio diversification, hedging, and protection against inflation.

Advantages of Exchange Traded Fund

- **Cost Efficiency:** ETFs are cost-effective as they don't involve making individual stock or security choices, eliminating the need for high-cost star fund managers.
- **Risk Avoidance:** Investors can steer clear of the risk associated with poor security selection by fund managers, all while benefiting from a diversified investment portfolio.
- **Carefully Selected Stocks:** The stocks in the indices are meticulously chosen by index providers and undergo periodic rebalancing.
- **Anytime Liquidity:** ETFs provide on-demand liquidity through exchanges, allowing investors to buy or sell at any time during market hours.

Disadvantages of Exchange Traded Fund

- **Expense Ratio Variability:** While many ETFs have low expenses, some may deviate from passive index tracking, leading to higher expense ratios.
- **Limited Active Management:** Passive management might limit the active decision-making seen in actively managed funds.
- **Market Price Variability:** ETF prices can fluctuate based on market demand and supply, potentially causing premiums or discounts to net asset value (NAV).
- **Lack of Personalization:** ETF portfolios are predetermined, limiting the customization options available to investors.

IGNITE YOUR MIND

Do you think Exchange Traded Funds (ETFs) offer a more cost-efficient and accessible investment option compared to traditional mutual funds?

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

The Securities and Exchange Board of India (SEBI) stands as a towering sentinel, safeguarding the interests of investors and ensuring fair play in the dynamic realm of Indian financial markets. But beyond its regulatory prowess, SEBI embodies a commitment to fostering healthy growth and promoting financial literacy across the nation.

Laws and Regulations

Main Laws

- **Securities and Exchange Board of India Act, 1992:** This is the foundation of SEBI's power and authority. It defines the board's objectives, functions, and powers to regulate the securities market.
- **Companies Act, 2013:** While primarily governing companies, it sets regulations for raising capital through public issues and protects investor interests related to listed companies.
- **Depositories Act, 1996:** Establishes the framework for depositories and depository participants, facilitating holding and settlement of securities in electronic form.
- **Foreign Exchange Management Act, 1999:** Regulates foreign exchange transactions in the securities market, including foreign investments and overseas offerings.
- **Securities Contracts (Regulation) Act, 1956:** It regulates the transactions in securities and the functioning of stock exchanges and aims to prevent undesirable practices in securities trading and to ensure fair and transparent dealings

Additional Regulations

- **SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018:** Specify disclosure requirements and listing norms for companies raising capital through the markets.
- **SEBI (Prohibition of Insider Trading) Regulations, 2015:** Outlines what constitutes insider trading and sets penalties for its violation.
- **SEBI (Investment Advisers) Regulations, 2011:** Govern the activities of investment advisors and mandate professional qualifications and ethical conduct.
- **SEBI (Mutual Funds) Regulations, 1996:** Regulate the operations and management of mutual funds to protect the interests of investors.

Headquarters

- The headquarters of SEBI is situated in **Mumbai**.
- The regional offices of SEBI are located in **Ahmedabad, Kolkata, Chennai and Delhi**.

Composition

- All decisions taken by SEBI are collectively taken by its Board which consists of a **Chairman and eight other members.**
- SEBI also appoints various committees, whenever required to look into the pressing issues of that time.

Functions of SEBI

Regulatory Oversight

- **Market Regulation:** SEBI formulates and enforces rules and regulations to govern the securities market. It oversees the functioning of stock exchanges, brokers, and other market participants to ensure fair and transparent operations.
- **Issues Regulations:** SEBI regulates the issuance of securities by companies, ensuring that the disclosure norms are followed, and investors receive accurate and timely information.

Investor Protection

- **Education and Awareness:** SEBI conducts investor education programs to enhance financial literacy, empowering investors to make informed decisions.
- **Preventing Frauds:** SEBI takes measures to prevent fraudulent and unfair trade practices, safeguarding the interests of investors.

Development of the Securities Market

- **Innovation Promotion:** SEBI encourages innovation in financial instruments and processes, fostering the development of new investment avenues in the securities market.
- **Market Infrastructure:** SEBI works towards enhancing the infrastructure of the securities market, ensuring efficiency, transparency, and accessibility.

Regulation of Intermediaries

- **Licensing and Registration:** SEBI issues licences and registrations to various market intermediaries, including brokers, portfolio managers, and investment advisers, setting standards for their conduct.
- **Monitoring and Surveillance:** SEBI monitors the activities of intermediaries to detect and prevent market abuses and misconduct.

Legal Framework

- **Legal EnforcementsL** SEBI has the authority to investigate and take enforcement actions against entities involved in market manipulation, insider trading, and other violations of securities laws.
- **Adjudication and Appellate Authority:** SEBI operates a quasi-judicial system for adjudicating disputes and has an appellate mechanism to review its decisions.

Corporate Governance

- **Listing Requirements:** SEBI prescribes listing requirements for companies, ensuring adherence to corporate governance norms and transparency in their operations.
- **Shareholder Protection:** SEBI promotes the interests of minority shareholders and ensures that companies act in the best interests of their shareholders.

Monitoring and Surveillance

- **Market Surveillance:** SEBI employs advanced surveillance systems to monitor market activities in real-time, identifying irregularities and taking prompt corrective actions.
- **Inspection and Audits:** SEBI conducts inspections and audits of market entities to ensure compliance with regulations and standards.

Investor Services

- **Investor Grievance Redressal:** SEBI operates a robust grievance redressal mechanism to address investor complaints, ensuring timely resolution.
- **Investor Protection Fund:** SEBI manages the Investor Protection Fund, providing a financial safety net for investors in case of default by market participants.

Global Integration

- **International Cooperation:** SEBI collaborates with international regulatory bodies and promotes global best practices, facilitating cross-border investments and ensuring alignment with international standards.

Policy Formulation

- **Policy Recommendations:** SEBI plays a key role in formulating policies related to the securities market, providing recommendations to the government on regulatory changes and reforms.

Challenges

While SEBI has undoubtedly made significant strides, it continues to face challenges:

- **Keeping pace with innovation:** The rapid evolution of financial technology and digital platforms necessitates constant adaptation and upgradation of regulations to ensure market integrity.
- **Addressing investor grievances:** Streamlining complaint redressal mechanisms and ensuring timely resolution of investor issues is crucial to maintain investor confidence and trust.
- **Promoting financial literacy:** Expanding financial education programs and making them accessible in regional languages is critical to empower a wider section of the population to participate in the financial markets.
- **Global Integration:** SEBI aims to enhance global integration, facilitating cross-border investments and collaborations to position India as an attractive investment destination.

IGNITE YOUR MIND

Do you think SEBI's emphasis on global integration is essential for India to attract foreign investments and align with international regulatory standards?

CAPITAL MARKET REFORM

Capital markets play a pivotal role in channelling funds from investors to businesses, facilitating economic growth. Recognizing the importance of a robust capital market, India has implemented various reforms to enhance efficiency, transparency, and investor protection.

Historical Context

Over the years, India has witnessed significant changes in its capital market landscape. Reforms have been introduced to align with global best practices and adapt to evolving economic dynamics.

Key Reforms

- **Dematerialization:** Transitioning from physical share certificates to electronic or dematerialized form streamlined trading and reduced risks of fraud.
- **Introduction of SEBI:** The establishment of the Securities and Exchange Board of India (SEBI) in 1988 brought regulatory oversight, ensuring fair practices, and safeguarding investor interests.
- **Liberalisation and Globalization:** Opening up the capital market to foreign investors increased liquidity, diversified investment options, and attracted foreign capital.

- **National Stock Exchange (NSE):** The creation of NSE in 1992 introduced electronic trading, bringing efficiency and transparency to the stock market.
- **Demutualization of Stock Exchanges:** Separating ownership and trading rights of stock exchanges minimised conflicts of interest and improved governance.
- **Market Integrity and Investor Protection**
  - SEBI's role in enforcing regulations ensures fair play, market integrity, and protection against fraudulent activities.
  - Stringent disclosure norms enhance transparency, providing investors with accurate information for decision-making.
- **Technological Advancements**
  - **Online Trading Platforms:** The advent of online trading platforms has democratised market participation, allowing investors easy access to the capital market.
  - **Blockchain Technology:** Exploring blockchain for settlement and record-keeping has the potential to further enhance security and reduce transaction costs.
- **Challenges and Future Prospects**
  - **Market Volatility:** Mitigating the impact of market volatility through regulatory measures and risk management strategies.
  - **Financial Inclusion:** Capital market reforms aim to make financial products accessible to a broader section of the population, promoting financial inclusion.

SECURITIES APPELLATE TRIBUNAL (SAT)

The Securities Appellate Tribunal (SAT) occupies a pivotal role in the Indian financial landscape, acting as an appellate authority that adjudicates disputes and appeals arising from decisions made by regulatory bodies, primarily the Securities and Exchange Board of India (SEBI). Established to ensure a fair and efficient securities market, SAT plays a crucial role in upholding the integrity and transparency of India's financial ecosystem.

Functions and Powers of SAT

- **Appellate Jurisdiction:** SAT primarily hears appeals against SEBI orders, providing a platform for entities and individuals to contest decisions that may impact their standing in the securities market.
- **Power to Review Decisions:** SAT has the authority to review and set aside, modify, or confirm SEBI orders, ensuring a thorough examination of the facts and legal aspects of each case.
- **Market-Related Disputes:** SAT deals with a range of disputes, including those related to insider trading, fraudulent and unfair trade practices, and other violations of securities laws.
- **Decisions on Regulatory Actions:** The tribunal evaluates SEBI's regulatory actions, including penalties imposed, ensuring that they align with legal principles and procedural fairness.
  - SAT's adjudicatory role extends to appeals filed against SEBI decisions related to delisting, disclosure norms, and various provisions of the Securities and Exchange Board of India Act, 1992.
- **Ensuring Fair Play:** SAT acts as a check on the regulatory authorities, ensuring that their actions are just, transparent, and in compliance with applicable laws.

Challenges

- **Case Backlog:** One of the challenges faced by SAT is the backlog of cases, necessitating measures to enhance efficiency and expeditiously resolve disputes.
- **Capacity Building:** Continuous efforts are required to enhance the capacity and expertise of SAT members to effectively handle complex financial market issues.
- **Adaptation to Market Dynamics:** Given the dynamic nature of financial markets, SAT needs to continually adapt its processes and regulations to address emerging challenges and innovations.

STOCK EXCHANGE

Stock exchanges act as market intermediaries, connecting buyers and sellers, ensuring fair pricing and preventing market manipulation. The exchanges enable companies to list and trade shares, and in doing so, they provide them a gateway for capital mobilisation, fueling innovation, entrepreneurship, and overall economic development.

Stock market indices, like India's Sensex and Nifty, serve as vital indicators of economic sentiment, reflecting investor confidence and signalling potential challenges.

Beyond Trading

- **Regulation and Governance:** Stock exchanges uphold fair trading practices, set rules, monitor activities, and impose penalties to ensure market integrity and investor protection.
- **Transparency and Disclosure:** Listed companies disclose financial performance and material information, providing investors with accurate and timely data for informed decision-making.
- **Innovation and Development:** Stock exchanges foster innovation by providing platforms for emerging sectors, such as technology and renewable energy, to raise capital and expand operations.

STOCK EXCHANGES IN INDIA

National Stock Exchange (NSE)

- **Incorporation and Recognition**
  - Established in 1992, NSE gained recognition as a stock exchange in 1993, with trading operations commencing in 1994.
  - It quickly became a trailblazer by being the first stock exchange globally to adopt electronic trading systems.
- **Introduction of NIFTY 50 Index:** In the fiscal year 1995-96, NSE launched the NIFTY 50 Index, a benchmark index representing the performance of the equity market.
- **Shift to Dematerialized Securities:** NSE played a pivotal role in transitioning to dematerialized securities, contributing to the modernization of the Indian financial market.

Bombay Stock Exchange (BSE)

- **Historic Establishment:** Founded in 1875, BSE is the oldest stock exchange in Asia, playing a significant role in shaping India's financial landscape.
- **Introduction of Sensex:** In 1986, BSE introduced the Sensex, the first equity index in India, designed to identify the top 30 trading companies on the exchange.
- **Global Recognition:** BSE ranks among the top 10 most valued exchanges globally, contributing to India's prominence in the international financial scene.
- **Diverse Trading Offerings:** BSE facilitates trading in equities, derivatives, and commodities, providing investors with a range of financial instruments.

Other Stock Exchanges in India

- **Calcutta Stock Exchange Ltd.:** Operational since 1908, Calcutta Stock Exchange has a rich history, initially trading in shares of plantations and jute mills.
- **Magadh Stock Exchange Ltd.:** A regional exchange contributing to local economic activities.
- **Metropolitan Stock Exchange of India Ltd.:** An emerging exchange playing a role in India's financial landscape.
- **India International Exchange (India INX)**
  - Inaugurated in January 2017, it operates as India's first international stock exchange, a subsidiary of BSE located at GIFT City in Gujarat.
  - Currently, INX offers derivative products, including equity, currency, and commodities derivatives, along with debt instruments like masala bonds and foreign currency bonds.
- **NSE IFSC Ltd. (NSE International Exchange)**
  - Incorporated in November 2016, NSE IFSC Limited is a wholly-owned subsidiary of NSE, located at the International Financial Services Centre (IFSC), GIFT City in Gujarat.
  - Similar to India INX, it offers a range of derivative products and debt instruments.

Importance of Stock Exchanges

- **Determining Fair Prices:** Stock exchanges facilitate continuous trading, aiding in the discovery of fair prices for publicly listed securities.
- **Facilitating Industrial Advancement:** By providing a platform for capital mobilisation, stock exchanges support industrialization, fostering economic growth.
- **Protecting Investors' Interest:** Stock exchanges enforce guidelines for listed entities, ensuring adherence to norms and safeguarding investors' interests.
- **Acting as Secondary Markets:** Stock exchanges provide liquidity, allowing investors to sell certain bonds, such as sovereign gold bonds (SGBs), within specific periods.
- **Reducing Corporate Dependency on Loans:** By enabling companies to raise capital through securities, stock exchanges reduce the reliance on loans, promoting financial sustainability.

Challenges of Stock Exchanges

- **Market Volatility:** Stock markets, inherently volatile, face challenges from economic fluctuations, political events, and investor sentiment, impacting both companies and investors.
- **Technological Disruptions:** High-frequency trading and algorithmic algorithms raise concerns about market manipulation, urging stock exchanges to adopt regulations and technology rapidly.
- **Investor Access and Inclusion:** While stock exchanges are more accessible, bridging gaps in financial literacy and market participation remains crucial for societal inclusion.

SOCIAL MARKET EXCHANGE

SMEs are distinct from traditional exchanges in their focus on listing not just companies, but social enterprises. These are organisations driven by a dual mission, generating profits and creating positive social or environmental impact. Think of a solar energy company empowering rural communities or a garment factory promoting women's empowerment. In SMEs, these enterprises can raise capital from investors who resonate with their mission and value their social impact alongside financial prospects.

SMEs Gaining Momentum

Several Factors are Propelling The Rise of SMEs

- **Growing Interest in Socially Responsible Investing:** Investors, especially millennials, are increasingly seeking investments that align with their values. SMEs provide a platform for them to contribute to social and environmental causes while potentially earning financial returns.

- **Evolving Regulatory Landscape:** Governments, recognizing the potential of social enterprises, are creating supportive regulations and facilitating the growth of SMEs. For example, India's BSE Social Stock Exchange, launched in 2018, is a notable example.
- **Technological Advancements:** Online platforms and digital tools are making it easier for SMEs to connect with investors, track their impact, and demonstrate their transparency. This builds trust and encourages wider participation.

Benefits of Social Market Exchanges

- **Fostering Social Impact:** SMEs provide the capital needed for social enterprises to scale their operations and reach more beneficiaries, accelerating their positive impact on communities and the environment.
- **Promoting Financial Inclusion:** SMEs can play a role in bringing new investors, particularly retail investors, into the market, diversifying the investor base, and fostering financial inclusion.
- **Innovation and Sustainability:** By supporting social enterprises focused on innovative solutions to social and environmental challenges, SMEs can contribute to a more sustainable future.

Challenges

Despite their promise, SMEs also face challenges:

- **Lack of Awareness:** Many investors remain unfamiliar with the concept of social impact investing and SMEs. Raising awareness and educating potential investors is crucial.
- **Standardising Impact Measurement:** Measuring and reporting social impact can be complex. Developing standardized frameworks and rigorous impact assessment methodologies is essential to build trust and ensure transparency.
- **Liquidity Concerns:** Compared to traditional markets, SME liquidity may be lower, making it difficult for investors to buy and sell shares quickly. Solutions like market-making programs need to be explored.

DEMAT ACCOUNT

A demat account, or dematerialized account, is a digital repository for managing financial securities electronically, akin to a bank account for securities, eliminating the need for physical certificates and allowing online tracking of investments and holdings

Key Features of a Demat Account

- **Convenience:** Demat accounts make it easy to buy, sell, and hold securities electronically. No more worrying about losing or damaging physical certificates.
- **Safety:** Your securities are held securely in the depositories, reducing the risk of theft or loss.
- **Transparency:** You can easily track your holdings and investment performance online.
- **Efficiency:** Demat accounts streamline the settlement process for trades, making it faster and more efficient.
- **Lower costs:** Demat accounts can help you save on transaction costs compared to holding physical certificates.

Challenges

- **Cybersecurity Concerns:**
  - The digital nature of Demat accounts poses cybersecurity challenges, necessitating robust security measures.
- **Technological Advancements**

Continuous technological advancements may lead to further innovations in Demat account services, enhancing user experience and security.

SHORT SELLING

Short selling, a sophisticated financial strategy, stands as a unique and controversial practice in the world of investing. This manoeuvre allows traders to profit from the decline in the value of an asset, presenting both opportunities and risks that set it apart from conventional investment approaches.

Short selling involves selling an asset, usually stocks, that the seller does not own. The process begins with borrowing the asset from a broker and selling it on the open market. The goal is to buy back the asset later at a lower price, thereby profiting from the difference.

Benefits and Drawbacks

- **Market Efficiency:** Short selling can inject liquidity into the market, facilitating price discovery and efficient allocation of capital. It can also act as a counterweight to excessive optimism, potentially preventing market bubbles.
- **Risk Hedging:** Investors can use short selling to hedge existing long positions, mitigating potential losses if the market takes a downturn.
- **High Risks:** Conversely, short sellers face the perilous possibility of significant losses. If the stock price rises, they must buy back the shares at a higher price, incurring substantial financial damage.
- **Market Manipulation Concerns:** Unrestrained short selling raises concerns about potential manipulation, which can exacerbate downward spirals in stock prices.

Recent Trends

While short selling offers advantages, it remains a contentious topic in India, often viewed with suspicion by retail investors. Concerns about manipulation and potential unfair advantages for institutional investors persist, placing regulators in the challenging position of balancing market vibrancy with investor protection.

Regulatory Measures

- **Short Sale Regulations:** Many financial markets have regulations in place to govern short selling, including restrictions on "naked" short selling, which involves selling shares without borrowing them first.
- **Market Surveillance:** Regulatory bodies actively monitor markets to detect and prevent any potential abuses related to short selling.

GOVERNMENT SECURITIES (G-SEC)

Government Securities, commonly referred to as G-Secs, constitute tradable instruments issued either by the Central Government or State Governments. They serve as a category of debt instruments through which the government secures funds from the public to address its Fiscal Deficit. In financial terms, a debt instrument represents an agreement wherein the issuer commits to paying the holder a predetermined sum of money, known as the principal or face value, on a specified future date.

Features of G-Secs

- **Maturity Periods:** G-Secs come with different maturity periods, ranging from short-term Treasury Bills (T-Bills) to long-term bonds.
- **Coupon Payments:** The government pays periodic interest, known as coupon payments, to the holders of these securities. The frequency of coupon payments depends on the terms of the security.
- **Market Dynamics:** G-Secs are actively traded in the secondary market, and their prices are influenced by factors such as interest rates, inflation, and overall economic conditions.

Types of G-Secs

- **Treasury Bills (T-Bills):** These are short-term securities with maturities of up to one year. T-Bills are issued at a discount to their face value, and the difference represents the interest earned.
- **Government Bonds:** These are long-term debt instruments with maturities typically exceeding one year. Government bonds pay periodic interest and return the principal amount upon maturity.
- **Zero-Coupon Bonds:** These bonds do not make periodic interest payments. Instead, they are issued at a discount and provide returns through capital appreciation, as they mature at face value.
- **Inflation-Indexed Bonds:** These securities are designed to protect investors from the eroding effects of inflation. The principal and interest payments are adjusted based on inflation rates.

Falling Yields on G-Secs

The yield on G-Secs is inversely related to their prices. When demand for these securities increases, their prices rise, leading to a decrease in yields. The recent trend of falling yields can be attributed to several factors:

- **Monetary Policy Actions:** Central banks often adjust policy rates to manage inflation and stimulate economic growth. Lower policy rates can lead to reduced yields on G-Secs.
- **Market Sentiment:** Investor perceptions and market sentiment contribute significantly to the demand for G-Secs. In times of economic uncertainty, investors may flock to these safe-haven assets, driving up prices and lowering yields.
- **Global Economic Conditions:** International factors, such as global interest rate trends and geopolitical events, can impact the yields on government securities.

Implications of Falling Yields

- **Investor Behaviour:** For investors, falling yields mean lower returns on their investments. This can influence investment strategies and push investors to explore alternative avenues.
- **Government Borrowing Costs:** While falling yields benefit the government by reducing the cost of borrowing, it may limit the returns for investors.
- **Economic Stimulus:** Central banks may adopt accommodative monetary policies, including lowering interest rates, to stimulate economic activity. This can contribute to the trend of falling yields on G-Secs.
- **Monetary Policy:** The Reserve Bank of India (RBI) has maintained an accommodative monetary policy stance in recent years, lowering interest rates to stimulate economic growth in the wake of the pandemic. This has increased liquidity in the financial system, driving up demand for G-Secs and pushing their prices higher, consequently lowering yields.
- **Inflationary Pressures:** While inflation remains a concern, recent data suggests a downward trajectory, raising expectations of further easing in monetary policy and keeping yields subdued.
- **Geopolitical Uncertainty:** Global economic uncertainties stemming from the Russia-Ukraine war and potential recessionary fears in developed economies have led investors to seek the relative safety of Indian G-Secs, further bolstering demand and driving down yields.

Challenges

- **Interest Rate Volatility:** G-Sec prices are highly sensitive to fluctuations in interest rates, posing challenges for investors as central banks adjust policy rates to manage economic conditions.
- **Inflationary Pressures:** The real value of fixed coupon payments on G-Secs is vulnerable to inflation, impacting investor purchasing power over time.
- **Market Liquidity Concerns**: Liquidity challenges in G-Sec markets, particularly in emerging economies, can complicate transactions for investors looking to buy or sell at desired prices.

- **Credit Risk and Downgrades:** While considered low-risk, sovereign credit downgrades can occur, affecting investor confidence and G-Sec prices.
- **Global Economic Influences:** G-Sec yields are influenced by global economic factors, and international events can impact demand for these securities, contributing to yield fluctuations.
- **Technological and ESG Risks:** Potential cybersecurity threats in G-Sec transactions and the growing emphasis on ESG factors in investments add additional layers of complexity and risk to the landscape.

IGNITE YOUR MIND

Do you think the recent trend of falling yields on G-Secs, driven by accommodative monetary policies, poses a challenge for long-term investors seeking stable returns? Share your views on the trade-offs between short-term economic stimulus and the potential impact on investor returns and behaviour.

COMMODITY MARKET

The commodity market, often perceived as a complex and opaque realm, is the engine that drives the global economy. From the coffee we sip in the morning to the gasoline powering our vehicles, commodities play a crucial role in our daily lives.

What are Commodities

- **Tangible goods:** Commodities are physical, tradable goods extracted from the earth or grown through agriculture, such as oil, metals, grains, and coffee.
- **Standardised contracts:** Commodities are traded based on standardised contracts, ensuring quality and facilitating global trade.
- **Underlying value:** The value of a commodity is determined by a combination of factors like supply and demand, production costs, and geopolitical events.

Types of Commodity Markets

- **Physical markets:** Traditional marketplaces where physical goods are traded, like agricultural exchanges and oil terminals.
- **Financial markets:** Derivatives like futures contracts and options are traded, providing opportunities for speculation and hedging against price fluctuations.

Players in the Commodity Market

- **Producers:** Extractors and growers of commodities, like oil companies and farmers.
- **Consumers:** Industries and individuals who use commodities in their production or daily lives, like fuel refineries and coffee drinkers.
- **Traders:** Intermediaries who facilitate buying and selling of commodities, often specialising in specific sectors.
- **Financial institutions:** Banks and investment firms offer financial products and services related to the commodity market, like lending and risk management.

Impact of the Commodity Market

- **Global economic engine:** The commodity market plays a vital role in international trade, influencing prices and influencing economic growth across countries.
- **Inflation and price stability:** Fluctuations in commodity prices can impact inflation, affecting the cost of living and business operations.
- **Investment opportunities:** Commodities offer investors alternative avenues for returns and portfolio diversification, though they come with inherent risks.

Significance of the Commodity Market

- **Price Discovery:** The market establishes fair prices for commodities, benefiting both producers and consumers.
- **Risk Management:** Hedging tools help farmers, businesses, and investors mitigate price risks and stabilise their operations.
- **Investment Opportunities:** Commodities offer alternative investment avenues for portfolio diversification and potential returns.
- **Economic Growth:** A thriving commodity market fuels various industries, promotes agricultural development, and contributes to overall economic growth.

Challenges and the Future of the Commodity Market

- **Sustainability concerns:** Environmental impact of resource extraction and climate change raise questions about responsible sourcing and future demand for certain commodities.
- **Geopolitical uncertainties:** Political instability in resource-rich regions can disrupt supply chains and cause price volatility.
- **Technological advancements:** Innovations in renewable energy and alternative materials may impact the demand for traditional commodities.

INTERNATIONAL FINANCIAL SERVICES CENTRES AUTHORITY (IFSCA)

The world of finance is constantly evolving, and India is actively carving its own path towards global integration. At the forefront of this journey stands the International Financial Services Centres Authority (IFSCA) and its brainchild – the International Financial Services Centres (IFSCs). Let's delve deeper into this intricate landscape:

About IFSCA

- **Establishment**
  - Established in 2020 under the International Financial Services Centres Authority Act, the IFSCA is a statutory body mandated to develop and regulate India's IFSCs.
  - It acts as the architect and guardian of these specialised financial hubs.

Mission

The IFSCA's vision rests on three key pillars:

- **Ease of Doing Business:** Streamlining regulations and procedures within IFSCs to attract foreign investments and simplify operations for businesses. Faster approvals and less red tape.
- **World-Class Regulatory Environment:** Establishing a robust framework that aligns with international best practices, fostering transparency and building trust for investors.
- **Innovation Hub:** Encouraging the development and adoption of cutting-edge financial technologies and products within IFSCs.

Headquarter

The IFSCA headquarters are strategically located in Gandhinagar, Gujarat, overlooking the nascent IFSC – Gift City. This proximity ensures efficient oversight and fosters a close working relationship.

IFSCs: Financial Gateways Beyond Borders

- **Beyond the Domestic Curtain:** IFSCs are specialised financial hubs catering primarily to customers outside the domestic economy. They are designated zones where financial activities transcend national borders, operating under their own set of regulations, often less stringent than domestic ones.
- **Global Giants and Rising Stars:** Established IFSCs like London, Singapore, and New York are prominent examples. Emerging contenders like Shanghai and Dubai are also making their mark on the global stage.
- **India's Hybrid Approach:** India has opted for a hybrid model for its first IFSC in Gift City. This means aiming to combine the strengths of both domestic and international business, similar to the successful model of Singapore. It is leveraging India's domestic market while embracing global best practices.

Advantages

- **Global Investors, Welcome Aboard:** IFSCs provide a platform to attract foreign investments, boosting India's access to capital and fueling economic growth. It opens doors to a vast pool of international funds.
- **Fundraising Freedom for Indian Businesses:** Indian companies can access global financial markets through IFSCs, unlocking new avenues for raising funds and expanding their reach. Helps Indian startups scaling up their operations on a global stage.
- **Tax Perks and More:** Entities operating in IFSCs often enjoy tax benefits, relaxed foreign exchange regulations, and other incentives, making them attractive destinations for businesses. It is a competitive environment that incentivizes investment and growth.
- **FinTech Hub Potential:** IFSCs can foster the development of fintech companies, leveraging India's skilled workforce and creating a vibrant ecosystem for financial innovation. It is a hub buzzing with tech-savvy minds shaping the future of finance.

Building Blocks of IFSC

Several key factors contribute to an IFSC's success:

- **Robust Legal and Regulatory Framework:** Clear, transparent, and internationally aligned regulations are essential to ensure investor confidence and prevent misuse.
- **Thriving Local Economy:** A strong domestic economy provides a stable foundation for the IFSC to flourish.
- **Political Stability:** A predictable and stable political environment is crucial for attracting long-term investments. Imagine a climate of trust and confidence that encourages investors to put down roots.
- **Top-Notch Infrastructure:** World-class infrastructure, including communication networks, transportation, and digital connectivity, is essential for smooth operations. Providing a seamless flow of information and resources within the IFSC.
- **Strategic Location:** Proximity to major financial centres and key markets can significantly boost an IFSC's appeal. Think of a location that connects the IFSC to the global financial heartbeat.
- **Quality of Life:** A comfortable and attractive living environment attracts talent and fosters a thriving community. A vibrant ecosystem where skilled professionals choose to live and work.

India's Vision

With the IFSCA at the helm and Gift City as its pilot project, India is poised to make its mark on the global financial landscape. By embracing innovation, fostering a conducive environment, and overcoming challenges.

SPOT EXCHANGES

In the dynamic world of commodities, spot exchanges play a crucial role. These specialized platforms facilitate the immediate purchase and sale of physical goods like agricultural produce, metals, and bullion through "spot delivery contracts."

This means that upon agreeing on a price, the buyer receives the goods and the seller receives payment promptly, without any delays or intermediaries.

India's Spot Exchange Landscape

Currently, four spot exchanges operate in India:

- **National Spot Exchange Ltd (NSEL)**
- **NCDEX Spot Exchange Limited**
- **Reliance Spot Exchange Limited**
- **Indian Bullion Spot Exchange Limited**

These exchanges provide a transparent and efficient platform for the market participants, including farmers, traders, and businesses, to connect and engage in transactions.

Benefits of Spot Exchanges

Beyond simply facilitating immediate transactions, spot exchanges offer several advantages:

- **National Market Creation:** By bringing buyers and sellers from across the country together, spot exchanges promote price transparency and foster a national market for various commodities. This allows for a smoother flow of goods, fairer pricing, and improved market efficiency.
- **Demand and Supply Insights:** Spot exchanges act as barometers, reflecting the real-time demand and supply dynamics of different commodities. This valuable information empowers market participants to make informed decisions and helps policymakers formulate appropriate economic strategies.
- **Reduced Role of Middlemen:** By connecting buyers and sellers directly, spot exchanges cut out the need for intermediaries, potentially leading to lower transaction costs and fairer prices for both parties.

Understanding Spot Exchange Rates

While spot exchanges deal with physical commodities, the world of finance has its own parallel concept: the spot exchange rate. This dynamic figure represents the current market price of exchanging one currency for another. It essentially tells you the instantaneous value of a dollar in euros, rupees, or any other currency.

Birthplace of Rates

The spot rate generally emerges from the foreign exchange (forex) market, a global network of banks and traders constantly buying and selling currencies. Their collective actions, driven by supply, demand, and economic factors, determine the ever-changing spot rate.

Governments and Currencies

Some governments choose to intervene in this dynamic process, actively setting or influencing spot rates through mechanisms like currency pegs. This involves linking their currency's value to another, stronger currency, in an attempt to achieve stability and predictability in their exchange rates.

Guiding Light for Traders

For currency traders, the spot rate is a crucial indicator. They track its movements to identify profitable opportunities not only in the immediate spot market but also in other financial instruments like futures, forwards, and options, navigating the complex world of global finance.

GLOBAL DEPOSITORY RECEIPT (GDR)

In the dynamic landscape of global finance, where capital flows transcend borders and opportunities lie across continents, a unique instrument facilitates seamless cross-border investment: the Global Depository Receipt (GDR).

GDRs – negotiable instruments issued by a depositary bank in, say, London, representing a predetermined number of shares in that Indian company. These GDRs trade on the London Stock Exchange, making the Indian company accessible to investors there, effectively bridging the geographical gap.

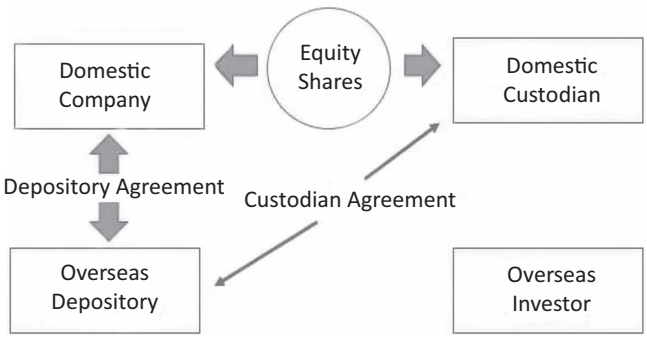


Fig. 10.2: Global Depository Receipts (GDR)

Why GDRs Matter

GDRs are more than just bridges; they offer a multitude of benefits for both companies and investors:

- **Capital Expansion:** Companies can tap into new pools of capital by issuing GDRs, accessing diverse investor bases beyond their domestic markets. This can fuel growth strategies and propel them onto the global stage.
- **Global Reach:** For investors, GDRs unlock the doors to promising companies listed abroad, broadening their portfolio diversification and potentially capturing higher returns through exposure to different markets and economies.
- **Enhanced Liquidity and Visibility:** GDRs create additional trading avenues for the underlying shares, facilitating easier transactions and attracting more investors. This can boost the company's global visibility and reputation, leading to a more robust market presence.

Working of GDR

Each GDR represents a specific number of shares in the issuing company, known as the conversion ratio. This ratio determines the value of the GDR based on the performance of the underlying shares. GDRs are traded on local stock exchanges, just like domestic shares, making them familiar and accessible to local investors. Importantly, they are usually denominated in the currency of the local market where they trade, further easing access and reducing foreign exchange risks for domestic investors.

Challenges and Considerations

While GDRs offer significant benefits, they are not without challenges:

- **Regulatory Landscape:** Both the issuing company and the depositary bank are subject to regulations in their respective jurisdictions, adding complexity to the process.
- **Currency Fluctuations:** Fluctuations in exchange rates can impact the value of both GDRs and the underlying shares, introducing additional risk for investors.
- **Market Liquidity:** Liquidity concerns may arise in some markets, particularly for smaller companies or those with limited track records.
- **Cost Implications:** Issuing and maintaining GDR programs can involve significant costs for companies, which need to be weighed against the potential benefits.

IGNITE YOUR MIND

Do you think the Indian government should implement any regulatory changes or provide additional incentives to encourage more Indian companies to utilize GDRs for fundraising? Discuss the potential economic and financial benefits for India of having a vibrant GDR market.

AMERICAN DEPOSITORY RECEIPTS (ADR)

- ADR, or American Depository Receipts, represent negotiable instruments that essentially embody shares of foreign companies traded on US stock markets.
- Issued by a US Depository bank, ADRs provide US investors with the opportunity to invest in foreign companies. They are actively traded on US Stock exchanges, serving as an attractive avenue for foreign companies seeking investment from the US.
- ADRs are listed on prominent exchanges like the **New York Stock Exchange (NYSE) or NASDAQ**, although they can also be transacted over the counter. The pricing of ADRs is denominated in US Dollars.

Types of ADR

ADR types traded in the US market can be classified into two categories:

- **Sponsored ADR**
  - Sponsored ADR involves a collaboration between a foreign company intending to issue shares publicly and a US Depository bank.
  - The US depository bank manages the sale, and distribution of shares to the public, record-keeping, and dividend distribution.
  - Sponsored ADRs are listed on US stock exchanges, regulated by the Securities and Exchange Commission (SEC), ensuring compliance.
- **Non-sponsored ADR**
  - Non-sponsored ADRs are generated by brokers and dealers independently, without direct involvement from the foreign company.
  - These ADRs are traded over the counter and don't require registration with the Securities and Exchange Commission (SEC).

Advantages of ADR

The advantages of ADR include

- **Global Investment Opportunities:** American investors can diversify their portfolio by investing in various foreign companies, potentially leading to higher returns.
- **Enhanced Market Presence:** Foreign companies can enhance their market presence by getting listed on the US Stock Exchange, opening avenues for increased profit and capital.
- **Currency Fluctuation Benefits:** Companies can capitalise on currency fluctuations, potentially gaining advantages from favourable exchange rates.
- **Accessible US Market:** ADRs provide a convenient avenue for investors to participate in the US market without facing intricate hurdles.
- **Cost-Effective Pricing:** The pricing of ADRs in the US capital market is economical, presenting an appealing option for investors seeking cost-effective investment opportunities.

Disadvantages of ADR

The disadvantages of ADR include:

- **Delayed Returns:** Investors may experience prolonged waiting periods to realise substantial returns on ADR investments.
- **Foreign Exchange Risk**: ADRs expose investors to the risk of fluctuations in foreign exchange rates, impacting the overall investment value.
- **Limited Investment Options:** The number of companies opting for ADR registration is restricted, providing investors with a limited pool of choices for investment opportunities.

CENTRAL COUNTERPARTY CLEARING HOUSE

The financial landscape is a complex ecosystem, where risk and reward dance in a delicate tango. In this intricate ballet, a crucial player emerges: the Central Counterparty Clearing House (CCP).

It acts as a central clearing house for derivatives and securities transactions, interposing itself between buyers and sellers. Instead of directly dealing with each other, parties to a trade entrust their obligations to the CCP. This means the CCP becomes the buyer to every seller and the seller to every buyer, effectively guaranteeing the completion of the transaction.

Need for CCPs

The CCP plays a vital role in maintaining financial stability by mitigating several key risks:

- **Counterparty Risk:** In traditional transactions, each party bears the risk of the other party defaulting. The CCP eliminates this risk by guaranteeing the settlement of all trades, regardless of any individual party's default.
- **Systemic Risk:** If one party defaults in a traditional system, it can trigger a domino effect, leading to cascading failures across the market. The CCP acts as a firewall, containing the impact of defaults and preventing systemic contagion.
- **Improving Market Efficiency:** CCPs standardise and centralise clearing and settlement processes, leading to faster transaction times, lower costs, and increased market liquidity.
- **Enhancing Transparency:** CCPs provide comprehensive data on trading activities and risk exposures, promoting greater transparency and fostering market confidence.

Working of CCP

- The CCP operates through a sophisticated system of clearing and settlement:
- **Clearing**

  When a trade occurs, the CCP registers it and calculates the net obligations of each party.
  - This means it combines the positions of all buyers and sellers in a particular security or derivative, and assigns each party a single net obligation to the CCP.
- **Settlement**
  - On the settlement date, the CCP facilitates the exchange of funds and securities between parties, ensuring that each party receives their due.
  - This process is multilateral, meaning each party settles with the CCP directly, eliminating the need for individual bilateral settlements.

Types of CCPs

There are two main types of CCPs:

- **Guarantor CCPs:** These CCPs guarantee all trades by holding collateral from clearing members (banks and financial institutions).
- **Payment-versus-Payment (PvP) CCPs:** These CCPs only settle trades once both parties have made their payments, further mitigating risk.

Advantages of CCPs

The benefits of CCPs extend beyond individual transactions, impacting the broader financial system:

- **Enhanced Market Confidence:** By mitigating risk and ensuring settlement, CCPs promote investor confidence and encourage participation in the financial markets.
- **Financial Stability:** CCPs act as shock absorbers, minimising the impact of defaults and preventing systemic crises.
- **Regulatory Tool:** Governments can utilise CCPs to implement regulations and promote fair and efficient markets.

Challenges

CCPs are not without their challenges. Some key concerns include:

- **Concentration Risk:** As CCPs accumulate large positions in various assets, they become potential single points of failure themselves, requiring robust risk management and regulatory oversight.
- **Operational Complexity:**
  - Managing and clearing a high volume of complex transactions demands sophisticated technology and well-defined operational procedures.
- **Cost Implications:** Participation in CCP clearing can incur costs for market participants, which need to be balanced against the benefits of risk mitigation and efficiency.

Way Ahead

With the increasing interconnectedness and complexity of financial markets, the role of CCPs is likely to become even more important in the future. Advances in technology and international cooperation will be crucial in strengthening their risk management capabilities and ensuring their continued effectiveness in safeguarding the stability of the financial system.

INDIA GAS EXCHANGE (IGX)

India's natural gas landscape, traditionally dominated by government-regulated pricing and public sector players, is poised for a transformative leap. Enter the Indian Gas Exchange (IGX), a digital platform set to revolutionise the way imported natural gas is traded in the country. IGX started operations on 15th June 2020 the IGX promises to usher in a new era of transparency, efficiency, and market-driven dynamics.

Until now, India's natural gas market has been largely defined by government-dictated prices and a dominant public sector presence. The IGX marks a crucial departure from this model, ushering in a market-driven approach. Buyers and sellers of imported gas will have access to a dynamic online platform enabling transparent spot and forward contracts across three strategic hubs; **Dahej and Hazira in Gujarat, and Kakinada in Andhra Pradesh.**

Mechanism of IGX

It offers two key trading options:

- **Spot Market**
  - This platform facilitates immediate delivery of natural gas at a price agreed upon by the trading parties.
  - It is a dynamic market for fulfilling immediate needs and short-term transactions.
- **Forward Market**
  - Providing long-term stability and risk management, the forward market allows for pre-determined contracts for future delivery of natural gas.

- This offers certainty and predictability for long-term strategies and investment decisions.

A Distinct Path For Imported Gas

While domestic natural gas remains under the purview of government regulations, the IGX's initial focus is solely on imported gas. This highlights the evolving nature of India's natural gas sector, where the reliance on imported gas is expected to grow significantly in the coming years.

Advantages of The IGX

The IGX's arrival promises several exciting possibilities for the Indian natural gas market:

- **Enhanced Market Access and Liquidity:** The digital platform's convenient access and transparent trading mechanisms are expected to attract more participants, creating a more liquid and accessible market for both buyers and sellers of imported gas.
- **Improved Price Discovery and Transparency**
  - By allowing market forces to determine the price of imported gas, the IGX can lead to greater price transparency and discovery.
  - This can potentially lead to more efficient resource allocation within the sector.
- Effective Risk Management Tools
  - The availability of forward contracts on the IGX empowers market participants to hedge against price fluctuations and manage risk more effectively.
  - This enables informed decision-making and greater confidence in navigating the market.
- Stimulating Competition and Efficiency
  - The IGX's presence can potentially introduce healthy competition among market players, potentially leading to improved efficiency and lower costs for consumers in the long run.

FOREIGN ACCOUNT TAX COMPLIANCE ACT

In the intricate world of international finance, where capital flows across borders and investments whisper promises, a crucial piece of legislation stands watch, the Foreign Account Tax Compliance Act (FATCA). Designed to combat overseas tax evasion by US citizens and residents, FATCA casts a wide net, impacting financial institutions and individuals alike.

Purpose of FATCA

The act aims to:

- **Reduce tax evasion:** By requiring foreign financial institutions (FFIs) to report information on accounts held by US citizens and residents, FATCA makes it harder to hide assets and income abroad.
- **Increase tax revenue:** By capturing previously unaccounted-for income, FATCA potentially bolsters US tax coffers, contributing to public finances.
- **Promote transparency and collaboration:** FATCA establishes frameworks for information exchange between the US and other countries, fostering greater international cooperation and transparency in tax matters.

Mechanism of FATCA

Think of FATCA as a two-pronged approach:

- **Information Reporting**
  - FFIs in countries with intergovernmental agreements (IGAs) with the US are obligated to identify and report accounts held by US citizens and residents to the Internal Revenue Service (IRS).
  - This includes details like account balances, interest income, and dividends.
- **Withholding at Source**
  - For FFIs in countries without IGAs, FATCA may impose a 30% withholding tax on certain US-source income payments, like dividends and interest, made to accounts potentially held by US taxpayers.
  - This serves as an incentive for such FFIs to enter into IGAs and comply with reporting requirements.

Implications For Financial Actors

FATCA's reach extends beyond US taxpayers and encompasses financial institutions worldwide. For FFIs, compliance can involve:

- **Implementing due diligence procedures:** Identifying and verifying US account holders.
- **Reporting account information:** Submitting data to the IRS regularly.
- **Withholding tax at source:** For FFIs in non-IGA countries, applying the 30% withholding tax as necessary.

Advantage to FFIs

- **Reduced risk of penalties:** Complying with FATCA mitigates the risk of hefty fines and sanctions from the IRS.
- **Improved market access:** Compliance could enhance reputation and potentially attract US clients.
- **Promoting global tax compliance:** FFIs play a crucial role in fostering a fairer and more transparent global tax system.

Future of FATCA

As financial markets remain interconnected and global tax evasion persists, FATCA is likely to evolve and adapt. Future developments could include:

- **Expansion of IGAs:** More countries may enter into IGAs with the US, streamlining information exchange and reducing the burden on FFIs.
- **Technological advancements:** Enhanced data sharing and reporting platforms could simplify compliance requirements for both FFIs and the IRS.
- **International cooperation:** Broader collaboration between tax authorities worldwide could further strengthen the fight against global tax evasion.

IGNITE YOUR MIND

Do you think FATCA strikes an appropriate balance between combating tax evasion and respecting individual privacy rights? Share your views on the potential ethical considerations and challenges associated with the broad information reporting requirements imposed by FATCA on foreign financial institutions.

CREDIT RATING AGENCIES

In the dynamic world of finance, where investments bloom and risks lurk, credit rating agencies (CRAs) play a crucial role in assessing the financial health of entities.

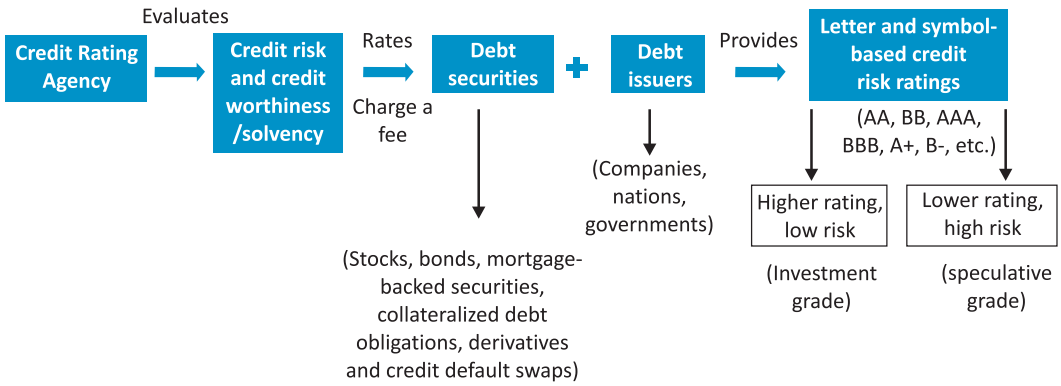


Fig. 10.3: What Credit Rating Agencies do?

Role of CRAs

They analyse financial statements, debt levels, economic factors, and more to assign letter grades reflecting the creditworthiness of an entity. These grades, from the reassuring "AAA" to the cautionary "D", serve as a shorthand for trust, guiding investors, lenders, and insurers in their decisions.

Impact of CRAs in India

In India, CRAs play a vital role in:

- **Facilitating Capital Flow:**
  - A high credit rating can unlock cheaper borrowing and attract wider investor interest, boosting economic activity and growth. Conversely, a downgrade can trigger capital flight and higher borrowing costs, impacting businesses and potentially hindering economic progress.
- **Promoting Financial Stability**
  - CRAs act as independent watchdogs, highlighting potential risks in the financial system.
  - This early warning system helps regulators and policymakers take necessary steps to maintain stability and prevent crises.
- **Enhancing Transparency**
  - CRAs provide valuable insights into the financial health of companies and governments, promoting transparency and accountability in the financial system.
  - This benefits investors, lenders, and the public alike.

Regulations and Challenges

The Indian CRA landscape is governed by the Securities and Exchange Board of India (SEBI). Six CRAs are currently registered with SEBI, including CRISIL, ICRA, and CARE Ratings. However, concerns exist regarding:

- **Concentration Risk:** The dominance of a few large CRAs raises concerns about potential conflicts of interest and systemic risk.
- **Regulatory Framework:** The evolving nature of financial instruments and markets necessitates continuous updates to the regulatory framework to ensure the effectiveness of CRAs.
- **Transparency and Credibility:** Maintaining transparency in the rating process and ensuring the independence of CRAs are crucial for upholding their credibility and public trust.

Way Forward

As India's financial markets continue to grow and evolve, the role of CRAs will undoubtedly become even more important. To ensure a robust and effective system, stakeholders must focus on:

- **Strengthening Regulatory Oversight**
  - Regular review and updates to the regulatory framework are essential to address emerging risks and ensure the integrity of the system.
- **Promoting Competition and Diversity**
  - Encouraging the entry of new players and diversifying the CRA landscape can help mitigate concentration risk and potentially improve the overall quality of ratings.
- **Embracing Innovation**
  - CRAs should adapt to technological advancements and incorporate new data sources into their methodologies to provide more accurate and nuanced assessments.

External Sector

11

INTRODUCTION

The External sector of an economy encapsulates its interactions with the global realm, involving trade, financial flows, and cross-border movements. It is a pivotal aspect shaping a nation's economic performance and global competitiveness. Its influence on economic growth, stability, and policy decisions highlights its significance in today's interconnected world. Therefore, effectively managing this sector is the key for sustainable development and gauging a country's role in the global economy as well as its standing and potential in the international arena.

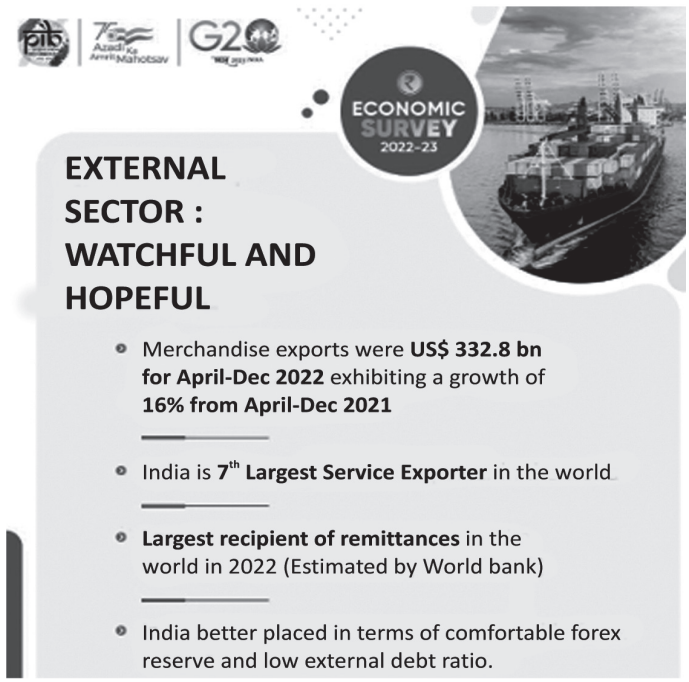

ECONOMIC SURVEY 2022-23
EXTERNAL SECTOR : WATCHFUL AND HOPEFUL
Merchandise exports were US$ 332.8 bn for April-Dec 2022 exhibiting a growth of 16% from April-Dec 2021
India is 7th Largest Service Exporter in the world
Largest recipient of remittances in the world in 2022 (Estimated by World bank)
India better placed in terms of comfortable forex reserve and low external debt ratio.

Fig. 11.1: A Glance at India's External Sector

BALANCE OF PAYMENTS

The Balance of Payments (BOP) represents the yearly financial record detailing the monetary dealings between a country's residents and the rest of the world. These transactions take place due to:

- Trade involving goods (also known as merchandise or visibles).
- Transactions related to services (also referred to as invisibles).
- Capital-based transactions such as loans, deposits, and investments.

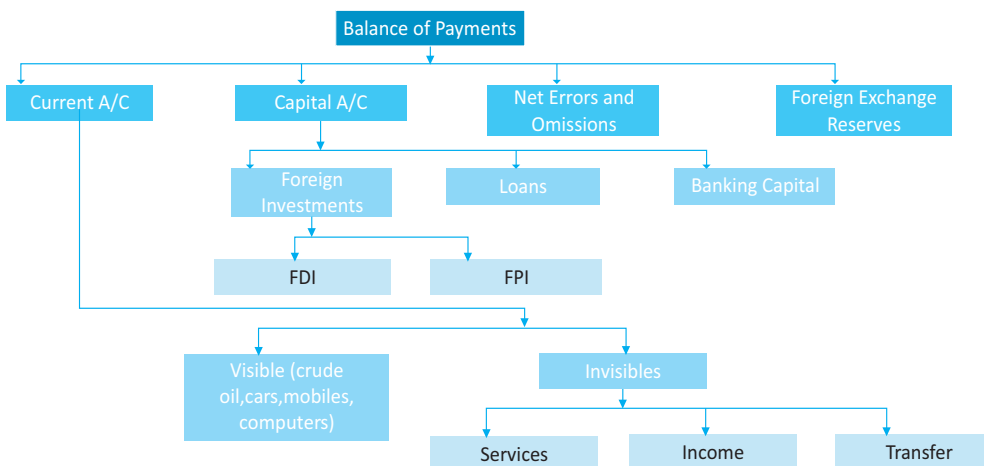


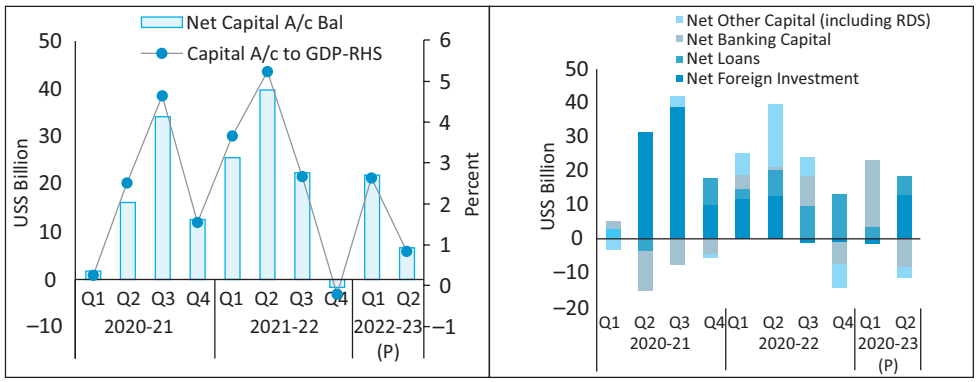
Fig. 11.2: Balance of Payments

Components of India's BoP

- **Current account:** This section tracks the flow of goods, services, and income between India and the rest of the world.
- **Goods:** This includes exports and imports of physical goods, such as textiles, electronics, and agricultural products.
- **Services:** This includes exports and imports of intangible services, such as tourism, software development, and financial services.
- **Income:** This includes income earned by Indian residents from foreign investments and income earned by foreign residents from Indian investments.
- **Current transfers:** This includes unilateral transfers, such as gifts, grants, and the aid received from abroad.
- **Capital account:** This section tracks the flow of financial assets and liabilities between India and the rest of the world.
- **Foreign direct investment (FDI):** This includes investments made by foreign companies in Indian businesses.
- **Portfolio investments:** This includes investments in stocks, bonds, and other financial instruments.
- **Other investments:** This includes loans, deposits, and other financial transactions.
- **Financial account:** This section tracks changes in India's official reserve assets, such as gold and foreign exchange reserves.

Balance of Current Account

The **(Current Account)** CA tracks all transactions involving goods, services, and income between residents and non-residents during a specific period. It acts like a scale, weighing the inflows (exports, income earned abroad) against the outflows (imports, income paid abroad). A balanced CA signifies a healthy equilibrium, while imbalances can reveal potential economic vulnerabilities.



a. Capital Account Balance: Narrowing surplus amid global uncertainty:

b. Composition of Capital Account Balance

Fig. 11.3: Balance and Composition of Capital Account

The Current Account Comprises Two Main Components

- **Balance of Visibles or Balance of Trade (BOT):** This measures the difference between the value of exports and imports of physical goods like machinery, food, and manufactured products. A positive BOT indicates a trade surplus, where exports outpace imports, while a negative BOT signals a trade deficit.
- **Balance of Invisibles:** This captures the flow of income and services like tourism, transportation, financial services, and intellectual property. A **positive balance indicates net earnings** from these services, while a **negative balance means net payments** to foreign providers.

The Overall Current Account Balance Offers Valuable Insights

- **Trade Surplus:** A sustained surplus suggests a strong export economy, potentially attracting foreign investment and boosting national income. However, excessive reliance on exports can also hinder domestic development.
- **Trade Deficit:** A persistent deficit can raise concerns about competitiveness and reliance on foreign goods. However, it can also be fueled by productive investments in capital goods for future growth.
- **Balanced Current Account:** A balanced Current Account indicates a healthy equilibrium where inflows and outflows are in check, signifying a stable and sustainable economic relationship with the global market.

Navigating The Desired Level of India's Current Account Deficit (CAD)

Current Account Deficit (CAD). It refers to the difference between the total value of goods and services a country exports and the total value it imports.

- **Exports:** The money you earn from selling your goods or services to other countries.
- **Imports:** The money you spend on buying goods or services from other countries.

A current account deficit occurs when you spend more on imports than you earn from exports. This means the country is borrowing from other countries to finance its purchases.

The Consensus and The Caveat

- **Rangarajan Committee Report (1993):** A widely accepted benchmark, the report suggested a CAD of around 2% of GDP as sustainable for India's long-term growth trajectory.
- **Current View:** RBI and Government: Recognizing the dynamic nature of the economy, they propose a slightly higher, "manageable" range of 2.5-3% of GDP.

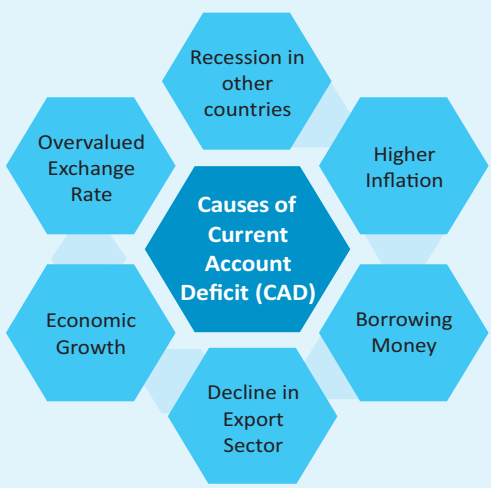


Fig. 11.4: Causes of Current Account Deficit (CAD)

Shock Absorber Argument

- **Y.V. Reddy's Perspective:** He argues that external shocks like economic downturns or oil price hikes can significantly widen the CAD beyond targeted levels.

- **Zero CAD as a Buffer:** To create room for these shocks, Reddy advocates aiming for a zero CAD in normal times, providing a buffer against external uncertainties.

The Current Scenario of India's Current Account Deficit (CAD) is a Mixed Bag

Positives

- **Lower deficit:** Compared to its recent peaks, India's CAD has come down significantly. The country's current account deficit (CAD) narrowed sharply to 1 per cent of the gross domestic product (GDP), in the second quarter (July-September) of financial year 2023-24 (FY24) compared to 3.8 per cent of GDP, in the same period last year.
- **Improved trade balance:** The trade deficit, a key component of CAD, has narrowed due to a combination of factors like falling global commodity prices, especially oil, and government measures to curb non-essential imports.
- **Rising net invisibles:** Earnings from invisible sources like software exports and remittances from abroad have been on the rise, partly offsetting the trade deficit.

Negatives

- **Vulnerability to external shocks:** Rising global uncertainties, including the ongoing Ukraine war and potential recessionary fears, could disrupt trade and put pressure on India's external sector.
- **Depreciating rupee:** The recent depreciation of the rupee could make imports more expensive and widen the trade deficit in the coming months.
- **Large external debt:** India's external debt remains high, making it vulnerable to sudden changes in global financial conditions.

The Balancing Act

While a zero CAD might offer shock-absorbing benefits, achieving and maintaining it can be challenging. Factors like global commodity prices, domestic demand, and export competitiveness play a significant role. Therefore, India's approach to CAD needs to be dynamic:

- **Medium-term Target:** Aiming for the 2.5-3% range seems prudent, providing a balance between growth and stability.
- **Policy Flexibility:** Maintaining a flexible policy framework, allowing for adjustments in response to external shocks remains crucial.
- **Boosting Exports:** Encouraging export diversification and competitiveness can help narrow the trade gap and reduce reliance on external borrowing.

Note: India's current account deficit (CAD) decreased from US$ 17.9 billion (2.1% of GDP) in Q1: 2022-23 to US$ 9.2 billion (1.1% of GDP) in Q1: 2023–24, per the recent RBI release, although it remained higher than the US$ 1.3 billion (0.2% of GDP) in the previous quarter.

Remittances: Lifelines For Individuals and Economies

- **Financial Lifeline:** Remittances are money transfers, often from migrants working abroad, to their families back home. They offer crucial financial support for basic needs like food, shelter, and healthcare.
- **Boosting Living Standards:** These funds not only alleviate poverty but also enable families to invest in education, healthcare, and small businesses, improving their overall well-being.
- **Development Drivers:** Remittances contribute significantly to the GDP of many developing countries, promoting economic growth and infrastructure development.
- **Global Impact:** They play a vital role in combating global poverty, as they often flow from developed countries to less developed ones, bridging the economic gap.
- **Beyond Economics:** Remittances strengthen social ties and cultural connections between migrants and their families, which fosters a sense of community and cultural exchange.

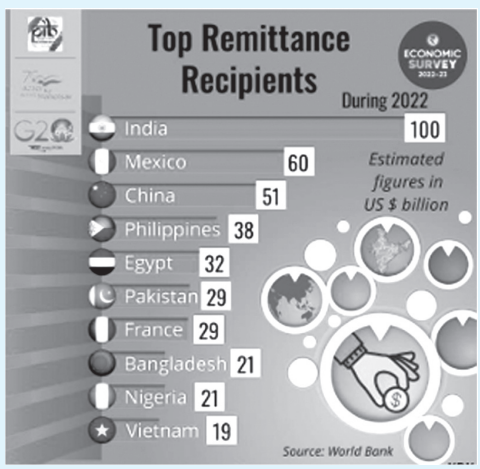


Fig. 11.5

- **LIBERALISED REMITTANCE SCHEME (LRS):**
  - The LRS of the RBI allows resident individuals to remit a certain amount of money during a financial year to another country for investment and expenditure.
  - According to the prevailing regulations, resident individuals may remit up to $250,000 per financial year.
  - This money can be used to pay expenses related to traveling (private or for business), medical treatment, studying, gifts and donations, maintenance of close relatives and so on.

Balance of Capital Account

Balance of capital account tracks the inflow and outflow of capital through investments and loans in an economy. Its components include:

- Overseas investments [comprising Foreign Direct Investment (FDI) and portfolio investment]
- Borrowings (external aid, ECB, and trade credit)
- Banking capital.

FOREIGN INVESTMENTS

Foreign Direct Investment (FDI)

Foreign Direct Investment (FDI) refers to the investment made by a company or individual from one country (foreign investor) into a business or enterprise operating in another country (host country). This investment involves a long-term commitment and a significant degree of control over the host country enterprise. Foreign Direct Investment (FDI) has emerged as a powerful engine driving India's economic transformation. Since the landmark liberalization of 1991, India has gradually opened its doors to foreign capital, paving the way for significant advancements in various sectors.

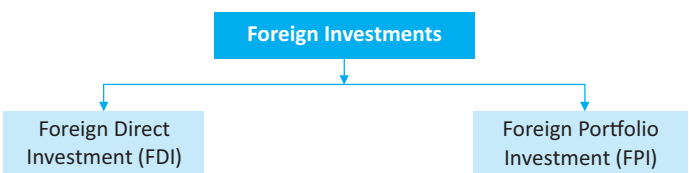


Fig. 11.6: Foregion Investments

Evolution of FDI Policy

- India's journey with FDI has been marked by a cautious and calibrated approach. Initial restrictions focused on high-priority areas, with "hyphen" products like Maruti-Suzuki symbolizing the early phase of joint ventures.
- Subsequently, brand names were allowed, followed by the removal of cumbersome restrictions like "dividend balancing."

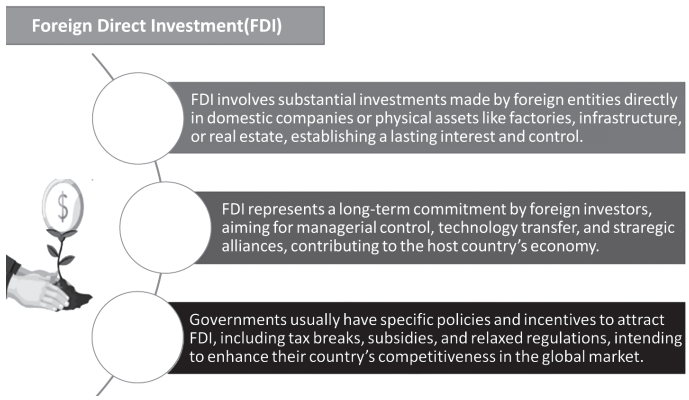

Foreign Direct Investment(FDI)
FDI involves substantial investments made by foreign entities directly in domestic companies or physical assets like factories, infrastructure, or real estate, establishing a lasting interest and control.
FDI represents a long-term commitment by foreign investors, aiming for managerial control, technology transfer, and straregic alliances, contributing to the host country's economy.
Governments usually have specific policies and incentives to attract FDI, including tax breaks, subsidies, and relaxed regulations, intending to enhance their country's competitiveness in the global market.

Fig. 11.7: Foregion Direct Investments (FDI)

- Today, the landscape is vastly different. With almost the entire economy open for foreign participation, sectors like **petroleum, power, and pharmaceuticals welcome 100% FDI.**
- While certain areas like insurance and banking have sectoral caps, the overall message is loud and clear: *India welcomes foreign investors.*

Key Features of FDI

- **Cross-border:** FDI involves the flow of capital across national borders.
- **Long-term commitment:** Foreign investors intend to hold their investments for an extended period, typically exceeding one year.
- **Control:** FDI often involves acquiring controlling interest or significant influence over the host country enterprise. This can be achieved through majority ownership, board representation, or other means.
- **Real assets:** FDI typically involves investments in real assets such as factories, equipment, land, or intellectual property.
- **Greenfield vs. Brownfield:** FDI can be either greenfield (investing in a new venture) or brownfield (investing in an existing enterprise).

Difference Between Greenfield Vs. Brownfield FDI

Feature	Greenfield FDI	Brownfield FDI
Investment Type	Building new facilities from scratch	Acquiring or leasing existing facilities
Level of Control	Complete control over design, construction, and operations	Limited control as existing infrastructure and regulations play a key role
Time to Start Operations	Longer – Requires construction and operational setup	Faster – Existing facilities can be adapted and operations started quickly
Financial Risk	Higher – More upfront costs and uncertain market demand	Lower – Lower initial investment and potentially established customer base
Regulatory Risk	Lower – New facilities can comply with latest regulations	Higher – May need to adapt to existing regulations and environmental impacts
Environmental Impact	Potentially lower – Can incorporate newer and cleaner technologies	Potentially higher – May inherit environmental issues associated with existing facilities
Examples	Building a new manufacturing plant.	Purchasing an existing hotel or factory.

Examples of FDI

- A Japanese car manufacturer is building a new factory in India.
- A US private equity firm acquiring a majority stake in a Chinese e-commerce company.
- A French technology company establishing a research and development centre in Brazil.

In the fiscal year 2022-2023, India witnessed total FD inflows of $70.97 billion, with FDI equity inflows reaching $46.03 billion. The top five contributors to FDI equity inflows were:

1. Mauritius (24%)
2. Singapore (23%)
3. The USA (9%)
4. The Netherlands (7%)
5. Japan (6%)

Impact of FDI

The influx of FDI has had a profound impact on various aspects of the Indian economy:

- **Capital infusion:** FDI has bridged the gap between domestic savings and investment, fueling infrastructure development, technological upgrades, and job creation.
- **Technology transfer:** Foreign companies bring in cutting-edge technologies and expertise, enhancing productivity and competitiveness across sectors.
- **Global integration:** FDI facilitates access to international markets, enabling Indian businesses to expand their reach and tap into global value chains.
- **Skill development:** Foreign companies invest in training and skill development programs, upskilling the Indian workforce and enhancing its employability.
- **Innovation and entrepreneurship:** FDI fosters a dynamic ecosystem of innovation and entrepreneurship, encouraging the development of new products, services, and business models.

Why India, Despite Advantages, Falls Short as a Top FDI Destination?

India boasts a seemingly irresistible combination for foreign investors: a large English-speaking workforce, cost-effective labour, abundant natural resources, a booming economy, and a second-largest market. Yet, despite opening up its doors and actively courting FDI, India often falls short of becoming a top destination.

Several Factors Contribute To This Paradox

- **Global Comparison:** Foreign investors do not operate in a vacuum. They compare India to other emerging economies like China, Brazil, and Korea. In this global competition, India struggles with:

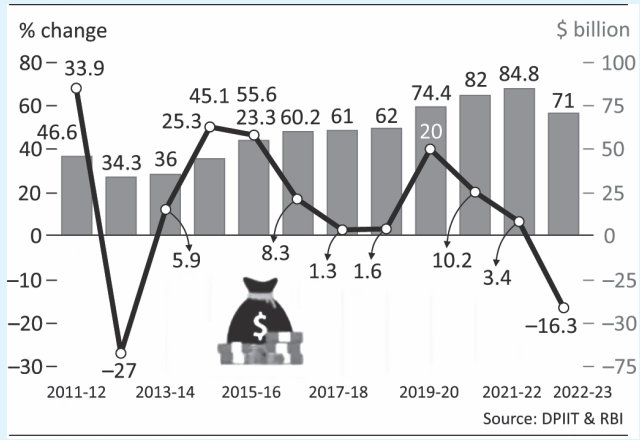


Fig. 11.8: Gross FDI in flows

  - **Infrastructure gaps:** India's infrastructure lags behind competitors, leading to logistical challenges and higher costs.
  - **Stringent labour laws:** Rigid labour regulations make it difficult for companies to operate efficiently and adapt to changing market demands.
  - **Dominant public sector:** The large presence of the public sector can create bureaucratic hurdles and opaqueness for private investors.
  - **Imperfect market:** Regulatory inefficiencies and lack of transparency can discourage investors seeking a predictable and level playing field.
- **Ease of Doing Business:** Despite the "single window" clearance system, multiple approvals at various levels, both central and state, continue to hinder smooth operations. This translates to delays, red tape, and frustration for investors.
- **Controversial Projects:** Cases like Enron, POSCO, and Vedanta have left a legacy of mistrust and uncertainty, raising concerns about project execution and potential regulatory hurdles.
- **Mindset Gap:** A perception persists that India is "doing them a favour" by allowing FDI, rather than recognizing the mutual benefits of foreign investment. This attitude can create friction and hinder genuine partnerships.
- **State Government Disparity:** The central government's enthusiasm for FDI isn't always mirrored at the state level, leading to inconsistencies and potential delays in project implementation.
- **Labour Market Rigidity:** Inflexible labour regulations, particularly around hiring and firing, can deter foreign investors seeking greater flexibility in managing their workforce.
- **Marketing Gap:** The message of India's open and welcoming FDI environment hasn't always reached the international audience effectively. Stronger marketing and outreach efforts are needed to showcase India's potential as an investment destination.

Addressing These Challenges Requires Multi-Pronged Efforts

- **Infrastructure development:** Prioritize infrastructure investments to improve connectivity and reduce logistical costs.
- **Labour market reforms:** Introduce flexibility while ensuring worker protections to attract and retain talent.
- **Streamlining bureaucracy:** Eliminate unnecessary approvals and cut down on bureaucratic red-tape to create a truly "single window" system.
- **Transparent regulations:** Implement clear and predictable rules to foster trust and confidence among investors.
- **Effective communication:** Actively promote India as an attractive FDI destination through targeted outreach and marketing campaigns.

Government Steps to Enhance FDI in India

Despite the challenges mentioned earlier, the Indian government has implemented various recent schemes to attract more FDI and propel economic growth. Here are some key initiatives.

IGNITE YOUR MIND

As India celebrates Azadi ka Amrit Mahaotsav in the year 2023, can you trace an evolution of India's external sector from 1947 to the present, especially keeping in mind the geopolitical trends and happenings during this period?

Government Bodies Regulating FDI

The **Department for Promotion of Industry and Internal Trade (DPIIT)** designs and enforces policies governing foreign investments, aiming to stimulate and supervise these investments across various sectors in India.

The **Reserve Bank of India (RBI)** oversees the financial aspects of foreign investments within the country, managing their monetary aspects.

The **Securities and Exchange Board of India (SEBI)** plays a regulatory role in foreign direct investment pertaining to the capital market in India.

- **Production Linked Incentive (PLI) Scheme:**
  - Launched in 2020, this scheme offers financial incentives to domestic and foreign companies for setting up or expanding production in 14 key sectors like automobiles, electronics, pharmaceuticals, and textiles.
  - The incentives can reach up to 50% of incremental sales for eligible companies.
  - Aims to attract global manufacturers, boost domestic production, and reduce dependence on imports.
- **Champion Sector Scheme:**
  - Launched in 2022, this scheme identifies 12 champion sectors with high export potential and focuses on attracting FDI in these areas.
  - It Offers customized support, including land allocation, fast-track approvals, and infrastructure development.
  - It Aims to make India a global leader in these sectors and boost exports.
- **National Infrastructure Pipeline (NIP):**
  - Launched for the FY 2020-2025, this ambitious plan outlines infrastructure projects worth ₹ 111 lakh crore ($ 1.5 trillion) during the period 2020-2025.
  - It provides a clear roadmap for investors and encourages private participation in infrastructure development.
  - It aims to improve connectivity, reduce logistics costs, and boost economic activity.
- **Single Window Clearance System:**
  - Established in 2021, this online platform simplifies the process of obtaining approvals from various government agencies for foreign investments.
  - This reduces paperwork, lowers processing time, and offers greater transparency.
  - It aims to make the FDI process smoother and more efficient.
- **Relaxation of Foreign Direct Investment (FDI) Norms:**
  - The government has gradually eased FDI restrictions in various sectors like insurance, banking, defense, and civil aviation.
  - This liberalization allows foreign investors greater access to the Indian market and promotes competition.
  - Aims to attract more foreign capital and expertise in key sectors.
- **Focus on Ease of Doing Business:**
  - The government has implemented various reforms to improve the business environment and make it easier for companies to operate in India.
  - This includes simplifying regulations, reducing bureaucratic hurdles, and improving online services.
  - Aims to attract more foreign investment and create a more competitive business environment.
- **Strengthening Intellectual Property (IP) Rights:**
  - The government has taken steps to strengthen the protection of intellectual property rights, which is crucial for attracting foreign investment in technology and innovation-driven sectors.
  - This includes implementing stricter enforcement measures and promoting awareness about IP rights.

- It aims to create a more secure environment for foreign investors and encourage technology transfer.

❑ **Promoting Start-ups and Innovation:**
- The government has launched various initiatives to support start-ups and foster innovation in India.
- This includes providing funding, mentorship, and access to infrastructure.
- It aims to attract foreign investment in the Indian start-up ecosystem and drive technological advancements.

Channels For Foreign Direct Investment (FDI) Into India

Two Paths for FDI into India: Indian companies can receive FDI through two distinct avenues:

❑ **Automatic Route:** FDI in specific sectors, as outlined in the consolidated FDI policy by the Government of India, is permissible without needing prior approval from the government or RBI.

❑ **Government Route:** Activities falling outside the automatic route necessitate government clearance.

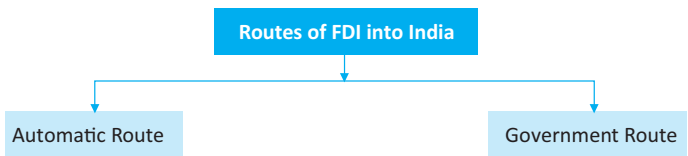


Fig. 11.9: Routes of FDI into India

Note:

❑ The Foreign Investment Promotion Board (FIPB), formerly responsible for overseeing this route, was dismantled in 2017. This change streamlined the process, attracting more FDI into India.

❑ An Indian company that has obtained FDI, whether through the automatic or government route, must adhere to the guidelines outlined in the FDI policy, including the obligation to report FDI to the RBI.

❑ According to the United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2023 disclosed,India secured the third-highest foreign direct investment (FDI) for new greenfield projects in 2022.

Sectors Where FDI is Prohibited

While India actively welcomes FDI in many sectors, there are some areas where foreign investment is prohibited or severely restricted for various reasons. Here's a breakdown:

Completely Prohibited

❑ **Lottery Business:** Including government and private lotteries, online lotteries, etc.

❑ **Gambling and Betting:** Casinos, etc.

❑ **Chit Funds:** A form of informal savings and lending scheme.

❑ **Nidhi Companies:** Borrowing and lending solely among members.

❑ **Trading in Transferable Development Rights (TDRs):** Instruments used for real estate development.

Restricted (Government Route Only)

❑ **Defence:** Strategic and sensitive technologies.

❑ **Agriculture and Plantation:** Certain activities within these sectors.

❑ **Civil Aviation:** Airlines, ground handling services, etc.

❑ **Retail Trading:** Multi-brand retail with FDI exceeding 51%.

❑ **Broadcasting:** News and current affairs channels.

Foreign Direct Investment (FDI) in Organized Retail: A Balancing Act

The arrival of foreign supermarket giants like Walmart has ignited a firestorm of debate in India, particularly regarding its impact on the ubiquitous "kirana stores" – the small, family-run shops that have long been the backbone of retail in the country. Let's delve into the complexities of FDI in organised retail, exploring both its potential benefits and the concerns it raises.

Defining the Terms:

❑ **Retail:** The sale of household necessities like food, clothing, and consumer goods, directly to consumers.

❑ **Organised Retail:** Selling branded products across counters in large stores, offering a standardised shopping experience.

FDI Options in India:

❑ **Franchise Route:** Foreign companies like McDonald's franchise their brand to Indian operators who run the stores.

❑ **Single-Brand FDI:** Investment in stores selling only one brand, like Arrow or Benetton.

❑ **Cash & Carry:** Companies sell products to Indian wholesalers who then retail them, like Spencer's.

❑ **Multi-Brand FDI:** Up to 51% equity investment (with certain restrictions) in stores selling multiple brands.

Arguments against FDI:

❑ **Threat to Kirana Stores:** The fear is that large retailers will drive smaller shops out of business, leading to unemployment and hurting the livelihoods of millions.

❑ **Consumerism and Exploitation:** Concerns exist that aggressive marketing and monopoly power could exploit consumers and stifle savings.

Potential Benefits of FDI:

❑ **Improved Practices:** Foreign companies bring expertise and best practices in supply chain management and inventory control, potentially leading to lower prices.

- **Wider Choice and Quality:** Increased competition can lead to a greater variety of products and improved quality standards for consumers.
- **Employment and Infrastructure:** Large retailers can create jobs and invest in infrastructure like cold-chain storage, benefiting farmers and the economy.
- **Government Revenue:** Taxes from these companies can contribute to government coffers.

Current Scenario and Misconceptions

- Unorganised retail still dominates India, accounting for over 90% of the market.
- Indian shopping habits differ from the West, with daily purchases being common, making it difficult for large stores to fully cater to all needs.
- Kirana stores offer personalised service and convenience, giving them a distinct advantage in certain segments.
- Walmart itself has acknowledged the unique challenges of the Indian market.

Foreign Direct Investment in Indian Agriculture: A Growing Potential

The agricultural sector, despite its crucial role in employing nearly 59% of the workforce and contributing 17% to India's GDP, has traditionally lagged behind other sectors in attracting foreign direct investment (FDI). However, recent trends indicate a promising shift, with FDI in agriculture steadily increasing in recent years.

Data and Trends

- As of December 2017, FDI in agriculture reached ₹611.28 crore, marking a significant rise from previous years (₹ 515.9 crore in 2016-17, ₹ 553.14 crore in 2015-16, and ₹ 365.31 crore in 2014-15).
- As of December 2022 (latest available data), FDI in agriculture has reached ₹ 1,915 crore, a significant jump from the ₹ 611.28 crore reported in December 2017.

Benefits of FDI in Agriculture:

- **Job creation:** FDI can create new employment opportunities in various aspects of the agricultural value chain, from farm production to processing and distribution.
- **Infrastructure development:** Foreign investment can contribute to building and upgrading critical infrastructure like cold storage facilities, irrigation systems, and rural transportation networks.
- **Technology transfer:** Collaboration with foreign companies can bring advanced technologies, knowledge, and best practices to Indian agriculture, leading to improved yields and efficiency.
- **Market access:** FDI can provide access to global markets for Indian agricultural products, promoting export growth and generating revenue for farmers and businesses.

Challenges and Considerations:

- **Land acquisition:** Concerns regarding land acquisition for large-scale agricultural projects need to be addressed to ensure fairness and protect the interests of small and marginal farmers.
- **Sustainability:** Environmental and social sustainability considerations must be integrated into FDI projects to ensure long-term benefits for communities and ecosystems.
- **Regulatory framework:** A robust regulatory framework is essential to protect consumer interests and prevent exploitation of farmers by foreign companies.

The Way Forward:

- **Public-private partnerships:** Public-private partnerships can play a crucial role in bridging the investment gap and mobilizing resources for infrastructure development and technology adoption in agriculture.
- **Focus on food processing:** Encouraging FDI in food processing industries can add value to agricultural produce, reduce wastage, and create additional job opportunities.
- **Skilling and training:** Investing in skill development programs for farmers and workers can equip them with the necessary skills to effectively participate in and benefit from FDI-driven initiatives.
- **Transparent and inclusive policies:** Clear and transparent policies that address concerns of all stakeholders are essential to ensure the success and sustainability of FDI in Indian agriculture.

FOREIGN PORTFOLIO INVESTMENT (FPI) IN INDIA

What is FPI?

Foreign portfolio investment (FPI) refers to investments made by foreign entities in Indian financial assets, primarily stocks and bonds. Unlike Foreign Direct Investment (FDI), which involves long-term commitments, FPI focuses on short-term gains and is more prone to volatility.

- **Small stake:** It typically involves owning less than 10% of shares in a listed company. In unlisted companies, any investment amount qualifies.

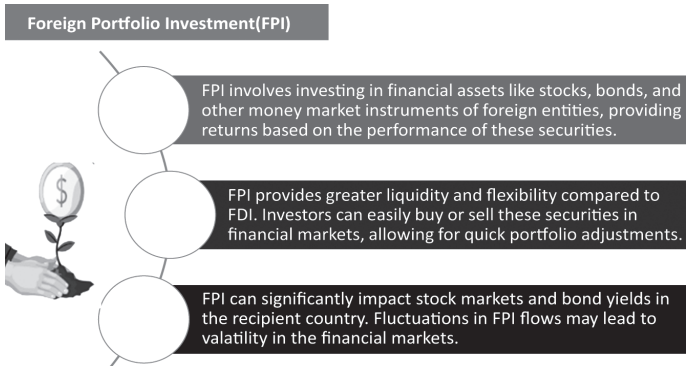

Foreign Portfolio Investment(FPI)
FPI involves investing in financial assets like stocks, bonds, and other money market instruments of foreign entities, providing returns based on the performance of these securities.
FPI provides greater liquidity and flexibility compared to FDI. Investors can easily buy or sell these securities in financial markets, allowing for quick portfolio adjustments.
FPI can significantly impact stock markets and bond yields in the recipient country. Fluctuations in FPI flows may lead to valatility in the financial markets.

Fig. 11.10: Foreign Portfolio Investment (FPI)

- **Easily traded:** These investments are readily bought and sold in financial markets, offering greater liquidity.
- **Short-term focus:** Portfolio investors often prioritize returns in the short to medium term, making them more susceptible to market fluctuations.

Types of Portfolio Investments

1. Foreign Institutional Investment (FII)

- Foreign Institutional Investment (FII) pertains to investments made by foreign individuals and institutional investors in securities of companies from other nations, predominantly in financial markets.

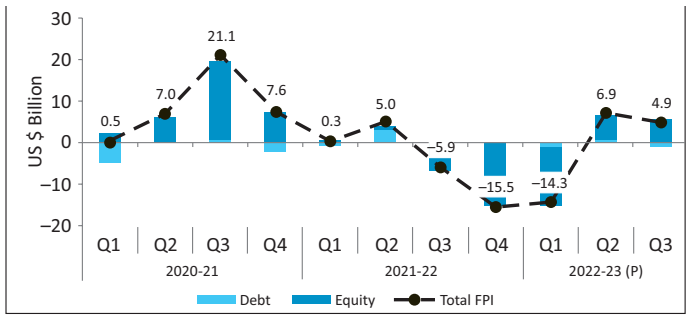


Fig. 11.11: Net Foreign Portfolio Investments

- FII is characterized by its short-term nature and often referred to as **'hot money.'**
- In India, Foreign Institutional Investments (FIIs) are regulated by the Securities and Exchange Board of India (SEBI).

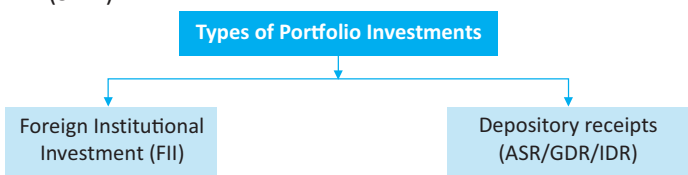


Fig. 11.12: Types of Portfolio Investments

- Foreign institutional investors are permitted to buy and sell securities on Indian stock exchanges but are required to be registered with SEBI.
- Investment by foreign institutional investors in India's primary and secondary capital markets is conducted exclusively through the country's Portfolio Investment Scheme (PIS).

2. Depository Receipts

These are special instruments that let you invest in foreign companies without directly owning their shares. Think of them as certificates representing shares held in a bank on your behalf.

Types of Depository Receipts

1. American Depository Receipts (ADRs)

- **Levels:** ADRs are further categorized into three levels based on the level of involvement the issuing company has in the program:
  - **Level I:** Unsponsored program; the foreign company does not actively participate, and a bank creates and issues ADRs based on market demand.
  - **Level II:** Sponsored program; the foreign company provides information and may market the ADRs but doesn't directly influence the program.
  - **Level III:** Fully sponsored program; the foreign company actively promotes and manages the ADR program, including investor relations and marketing.
- **Trading and Denominations:** ADRs trade on US stock exchanges, typically in US dollars, although some may be denominated in euros.
- **Dividends:** ADRs receive dividends from the underlying foreign shares, which are then typically converted to US dollars and paid to ADR holders.
- **Benefits for Investors:** ADRs offer access to foreign companies without opening foreign brokerage accounts or dealing with currency exchange. They also provide US dollar dividends and simplify tax reporting.
- **Examples:** Alibaba (BABA), Tencent (TCEHY), Nestle (NSRGY)

2. Global Depository Receipts (GDRs)

- **Issuance & Trading:** Similar to ADRs, GDRs represent shares of foreign companies but are issued and traded on various international stock exchanges, not just in the US.
- **Flexibility:** GDRs offer more flexibility in terms of denomination, potentially including local currencies alongside major currencies like USD or EUR.
- **Regulation:** Depending on the issuing country and exchange, GDRs may have different regulatory requirements compared to ADRs.
- **Benefits for Companies:** GDRs allow companies to access a wider pool of international investors and raise capital in different markets.
- **Examples:** Vodafone (VOD), L'Oreal (OREPY), Siemens (SIE)

3. Indian Depository Receipts (IDRs)

- **Purpose:** IDRs allow Indian companies to raise capital from Indian investors in rupee denominations, even if they are listed on overseas exchanges.
- **Eligibility:** Only companies with a track record of profitability and good corporate governance can issue IDRs.
- **Trading and Settlement:** IDRs trade on Indian stock exchanges and are settled in rupees.
- **Benefits for Investors:** IDRs offer exposure to well-established companies with international operations without the risks of currency fluctuations.
- **Examples:** Tata Motors (TTMT), ICICI Bank (ICICIBANK), HDFC Bank (HDFCBANK)

Benefits of Depository Receipts

- **Global access:** Invest in foreign companies without dealing with complex foreign markets.
- **Convenience:** Trade receipts locally in your own currency.
- **Risk diversification:** Spread your investment across different markets and currencies.

Growth of FPI in India

- FPI inflows have significantly increased in recent years due to liberalisation measures, although outflows remain volatile.
- As of now total FPI assets under custody (AUC) stand at over ₹ 51 trillion, as of 2021-22.
- This growth has played a significant role in deepening the Indian stock market and propelling its global standing.

Challenges of FPI in India

While Foreign Portfolio Investment (FPI) has played a crucial role in boosting the Indian stock market, its volatile nature and short-term focus pose several challenges for the Indian economy. Here's a breakdown of the key concerns:

Volatility

- **Sudden Outflows:** FPI flows can be highly sensitive to global market sentiment and domestic economic conditions. Large outflows can trigger market panic, currency depreciation, and financial instability.
- **Short-term Noise:** FPI's focus on short-term gains can lead to excessive speculation and market noise, making it difficult for long-term investors to invest efficiently.
- **Impact on Rupee:** Large FPI inflows can lead to rupee appreciation, making exports less competitive. Conversely, outflows can depreciate the rupee, impacting import-dependent sectors.

Short-term Focus

- **Limited Impact on Real Economy:** FPI primarily benefits the stock market and financial sector, but its impact on the broader economy, including job creation and infrastructure development, is limited.
- **Lack of Commitment:** FPI investors can withdraw their investments quickly, creating uncertainty for long-term projects and hindering sustainable economic growth.
- **Dependence on Foreign Sentiment:** The Indian market becomes vulnerable to global events and decisions by foreign investors, impacting domestic economic stability.

Other Challenges

- **Regulatory Issues:** There are various concerns regarding potential manipulation of the market by large FPI players and the need for robust regulatory frameworks to ensure fair play and investor protection.
- **Systemic Risks:** FPI's integration with the global financial system exposes India to potential systemic risks and contagion effects from global crises.
- **Concentration of Ownership:** Large holdings by a few FPI players can raise concerns about market concentration and potential control over Indian companies.

Potential Solutions

- **Development of Long-term Investment Strategies:** Encouraging long-term investment vehicles like pension funds and infrastructure funds to reduce volatility and promote sustainable growth.
- **Robust Regulatory Framework:** Strengthening regulations and oversight mechanisms to ensure fair market practices, prevent manipulation, and protect investors.
- **Diversifying Investment Sources:** Reducing reliance on FPI by promoting domestic investment and attracting alternative sources of foreign capital like FDI.
- **Developing Domestic Capital Markets:** Deepening and strengthening domestic capital markets to attract long-term investments and reduce reliance on FPI inflows.
- **Volatility:** FPI flows can be highly volatile, with sudden inflows or outflows potentially destabilising the economy.
- **Short-term focus:** The short-term nature of FPI can lead to rapid exits when market conditions change, impacting market stability.

Note:

The Tobin tax, proposed by economist **James Tobin**, suggests a small tax on currency conversions to deter short-term speculative trading and stabilize financial markets. It aims to discourage **rapid currency trades** by making them slightly more expensive, without significantly affecting long-term investments or regular trade. While intended to reduce market volatility and generate government revenue, challenges remain in implementing it universally due to concerns about its impact on liquidity and international trade, requiring global coordination among countries.

Difference Between FDI and FPI

Feature	Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Definition	Investment in a business or project in a foreign country with the intent of establishing or expanding a lasting interest and control.	Investment in financial assets in a foreign country, such as stocks, bonds, and mutual funds, with the focus on short-term capital gains.
Motivation	Long-term strategic interests, access to resources, market expansion, and control.	Short-term financial gains, diversification, and speculation.
Investment horizon	Long-term (years or decades)	Short-term to medium-term (days, weeks, months)
Control	Investor may seek majority ownership or control over the foreign entity	Investor does not seek control over the underlying assets.
Risk	Higher risk due to long-term commitment and potential instability in the foreign country.	Lower risk due to short-term involvement and liquidity of financial assets.
Impact on host country	Significant impact on employment, infrastructure development, and technology transfer.	Limited impact on the host country's economy.
Volatility	Relatively stable	Highly volatile, prone to sudden inflows and outflows.
Regulation	Subject to stricter regulations and approval processes.	Fewer regulatory hurdles than FDI.
Examples	Establishing a manufacturing plant, acquiring a local company, building a hotel.	Buying stocks, bonds, mutual funds, ETFs in a foreign market.

LOANS

Loans play a crucial role in the financial health of both individuals and nations. In the context of a country's **Balance of Payments (BOP),** loans represent the borrowings of both the government and private sectors from the international money market. These borrowings are known as debt-creating capital transactions and significantly impact the country's external financial position.

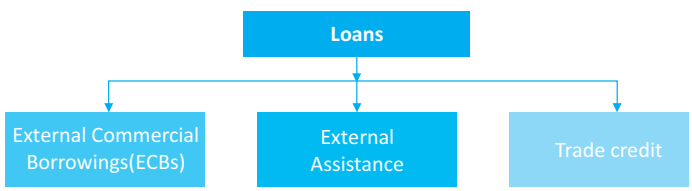


Fig. 11.13: Loans

External Commercial Borrowings (ECBs)

- **Market-driven loans:** ECBs are commercial loans raised from the international market at prevailing market interest rates, without any concessionary terms.
- **Eligible entities:** All entities eligible to receive Foreign Direct Investment (FDI) can raise ECBs. Additionally, certain institutions like Port Trusts, units in Special Economic Zones, and specific banks can also access ECBs.
- **Maturity requirements:** ECBs typically have a minimum average maturity of 3 years, although exceptions may exist.
- **Flexible currency options:** ECBs can be borrowed in any freely convertible foreign currency.
- **Diverse instruments:** ECBs come in various forms, including loans, bonds, debentures, and trade credit exceeding 3 years.

External Assistance

- **Concessional loans:** Unlike ECBs, external assistance comes with preferential interest rates and longer maturities.
- **Sources:** These loans are often provided by foreign governments, multilateral institutions like the World Bank and IMF, or other international monetary organisations.
- **Development focus:** External assistance is primarily aimed at supporting development projects and promoting economic growth.

Trade Credit

- **Facilitating imports:** Trade credit allows importers to pay for goods, both capital and non-capital, at a later date.
- **Limited access:** Only residents of India can avail trade credit.
- **Automatic route:** Specific industries like oil/gas and airlines have automatic access to higher trade credit limits.
- **Maturity periods:** Trade credit typically has a maximum maturity of 3 years for capital goods and 1 year for non-capital goods.

BANKING CAPITAL TRANSACTIONS

This pertains to the movement of foreign financial assets and liabilities managed by commercial banks and cooperative banks authorised as foreign exchange dealers. These encompass NRI deposits, which are facilitated through three distinct types of bank accounts:

Types of NRI Accounts and Their Features

1. Foreign Currency Non-Resident Account (FCNR-B)

- **Fixed Deposits only:** No savings accounts allowed.
- **Maturity term:** 1-5 years.
- **Eligibility:** Only NRIs and Persons of Indian Origin (PIOs) can open this account.
- **Currencies:** Pound Sterling, USD, Japanese Yen, Euro, Canadian $, Australian $, etc.
- **Benefits:** Attractive interest rates, tax-free returns on interest earned.
- **Drawbacks:** Prone to exchange rate fluctuations.

2. Non-Resident External Rupee Account (NRER)

- **Multi-purpose account:** Can be current, savings, or term deposit.
- **Eligibility:** Open to any NRI.
- **Purpose:** Remit funds to India conveniently.
- **Tax benefits:** Interest earned is tax-free.
- **Repatriation:** Both principal and accrued interest can be repatriated.
- **Risk:** Subject to exchange rate fluctuations.

3. Non-Resident Ordinary Rupee Account (NROR)

- **Wide access:** Open to anyone residing outside India, not just NRIs.
- **Purpose:** Manage income earned in India or conduct bona fide transactions in Indian Rupees.
- **Account types:** Current, savings, recurring, or fixed deposits.
- **Remittance limit:** Up to $1 million per year.
- **Taxation:** Interest earned is taxable.
- **Stability:** Not exposed to exchange rate fluctuations.
- **Tourists:** Can open an NROR account during their visit to India.

Impact on the Balance of Payments

- NRI deposits contribute positively to the capital account of the BOP.
- FCNR-B deposits bring in foreign currency, boosting foreign exchange reserves.
- NRER and NROR deposits can help finance current account deficits.
- These deposits can also stimulate investments and economic growth in India.

NET ERRORS AND OMISSIONS (NEO)

The Balance of Payments (BOP) strives to paint a complete picture of a nation's financial interactions with the rest of the world. But sometimes, things do not add up perfectly. This is where the NEOs come in, a mysterious entry balancing the BOP equation but leaving room for speculation.

What are NEOs?

NEOs represent the unexplained difference between all the recorded inflows and outflows in the BOP. They act as a balancing item, ensuring the entire account sums to zero. However, NEOs are not just a mathematical quirk; they point to unaccounted-for transactions or discrepancies in data collection.

Why do NEOs exist?

Several Factors can Contribute to the Existence of NEOs

- **Sampling Error:** Monitoring every single transaction across a nation's borders is practically impossible. Surveys and sampling techniques are used, but these can lead to undercounting or overcounting certain transactions.
- **Reporting Issues:** Businesses and individuals might under-report income or over-report expenses for various reasons, including tax avoidance or inaccurate record-keeping.
- **Hidden Activities:** Some transactions, like smuggling or illegal financial transfers, are deliberately hidden from official channels, further contributing to NEOs.

The Significance of NEOs

While a small percentage of GDP, NEOs can be indicators of underlying problems in the economy:

- **Large NEOs:** Persistent high NEOs may suggest significant underreporting or illegal activities, requiring further investigation.
- **Changes in NEOs:** Sudden fluctuations in NEOs can indicate shifts in economic activity or changes in reporting practices.

Challenges and Considerations

- Exchange rate fluctuations can impact NRI returns.
- Regulatory changes can affect the attractiveness of NRI accounts.
- Balancing the needs of NRIs with macroeconomic stability is crucial.

FOREIGN EXCHANGE RESERVES

Imagine a giant vault, overflowing with the world's currencies, safeguarding the economic stability of a nation. That's the essence of India's foreign exchange reserves, managed by the Reserve Bank of India (RBI), the country's financial custodian.

Total Foreigns exchange reserves excluding gold (in US$ bn)

	2005	2008	2019	2020	2021	Nov-2022	% change: 2021 over 2008
Russian Federation	175.9	411.8	443.9	457.0	497.6	567.3	20.8
India	131.9	247.4	432.4	549.1	594.4	555.3	140.3
Brazil	53.3	192.8	353.6	351.5	354.6	331.5	83.9
United States	54.1	66.6	118.4	133.9	240.2	237.8	260.7
United Kingdom	54.0	56.1	158.4	161.2	176.0	204.1	213.7
Indonesia	33.1	49.6	125.3	131.1	140.3	134.0	182.9
South Africa	18.6	30.6	48.9	47.4	50.3	60.0	64.4
Australia	41.9	30.7	55.6	39.2	53.8	57.9	75.2
World	4395.0	7418.2	12195.3	13122.5	13944.7	11598.6*	88.0

The Composition of India's Forex Reserves

1. **Foreign Currency Assets (FCAs):** These are the workhorses of the reserves, comprising over 90%. They include foreign currencies, deposits, and bonds held by the RBI. Think of them as India's kitty of global currencies, readily available for international transactions.
2. **Monetary Gold:** Gold, the timeless symbol of wealth, holds a significant place in India's reserves. While not directly contributing to foreign exchange transactions, it acts as a valuable hedge against economic uncertainties.
3. **Special Drawing Rights (SDRs):** These are, essentially, "IMF currency," created by the International Monetary Fund and allocated to member countries. They can be exchanged for other currencies, providing additional liquidity to India's reserves.
4. **Reserve Tranche Position (RTP) in the IMF:** This is a portion of India's quota in the IMF, which the country can access without additional requirements. Think of it as a line of credit with the IMF, further bolstering India's financial safety net.

Significance of Foreign Exchange Reserves

- **Confidence Booster:** Strong reserves inspire investor confidence and enhance India's creditworthiness in the global market. This translates to lower borrowing costs and improved access to foreign capital.
- **Import Buffer:** Reserves act as a buffer against import fluctuations, ensuring the country can continue to purchase essential goods even if foreign exchange earnings fall.
- **Currency Stability:** Reserves help manage exchange rate volatility, protecting the Indian rupee from sharp depreciations that can harm domestic businesses and consumers.
- **BOP Balance:** The overall Balance of Payments (BOP) plays a crucial role. A negative BOP can lead to a decrease in reserves, while a positive BOP can contribute to their growth, highlighting the interconnectedness of these reserves and the nation's external financial flow.

NAVIGATING THE TIDES OF BOP: A GLIMPSE INTO INDIA'S ECONOMIC JOURNEY

Period I (1956-57 to 1975-76): A Stormy Sea

This era was marked by heavy BOP deficits, battered by a series of external shocks:

- **Three wars:** The financial strain of armed conflicts left deep scars on the economy.
- **Droughts:** Agricultural shortfalls reduced exports and further strained the BOP.
- **Oil shock of 1973:** The sudden surge in oil prices crippled import affordability and widened the trade gap.

Period II (1976-77 to 1979-80): A Beacon of Hope

This period witnessed a golden moment for India's BOP:

- **Current account surplus:** For the first time, India achieved a current account surplus, exceeding 0.6% of GDP in one year.
- **Stronger export performance:** Improved economic policies and increased agricultural productivity boosted export earnings.
- **Foreign aid inflows:** Increased external assistance supplemented domestic resources and bolstered the BOP.

Period III (1980-81 to 1990-91): Approaching the Whirlpool

However, the tide turned again, leading to a severe BOP crisis:

- **Large trade deficits:** Mounting import bills, particularly for oil, outstripped export earnings, widening the trade gap.

- **Declining net invisibles:** Reduced remittances and lower earnings from services further weakened the BOP.
- **Reduced external assistance:** Dependence on foreign aid diminished, putting pressure on foreign exchange reserves.

India's 1991 Balance of Payments Crisis and The Road to Recovery

Imagine a nation on the brink, its economic engine sputtering, foreign currency reserves dwindling to a mere three weeks' worth of imports. This was India's harsh reality in 1991, facing a severe Balance of Payments (BOP) crisis that threatened its financial stability. Let's rewind and understand the storm that brewed and the winds of reform that eventually steered India towards calmer waters.

The Gathering Clouds

- **Gulf War and Oil Shock:** The 1990 Gulf War sent global oil prices skyrocketing, crippling India's import-heavy economy. As a net oil importer, India's import bill ballooned, draining its foreign exchange reserves.
- **Cumulative Economic Woes:** Decades of protectionist policies, government inefficiencies, and high fiscal deficits had weakened India's competitiveness and export potential.
- **Capital Flight:** The escalating crisis spooked foreign investors and Non-Resident Indians (NRIs), leading to a substantial outflow of deposits, further depleting reserves.

The Brink of Collapse

By January 1991, India's foreign exchange reserves had plummeted to a mere $0.9 billion, barely enough to cover three weeks' worth of imports. International rating agencies downgraded India, pushing its creditworthiness to the edge. The nation stood on the precipice of a financial meltdown.

Turning The Tide

Faced with this dire situation, the Indian government, with an IMF-backed bailout, embarked on a series of bold reforms:

- **Rupee Devaluation:** The overvalued rupee was devalued, making exports more competitive and discouraging non-essential imports. This signaled a shift towards a market-oriented economy, attracting foreign investors.
- **Export Promotion:** Incentives were introduced to boost exports, diversifying the economy and reducing dependence on imports.
- **Fiscal Consolidation:** Strict measures were taken to control government spending and reduce fiscal deficit, improving India's macroeconomic stability.
- **Structural Reforms:** Red tape was slashed, public sector industries were reformed, and private sector participation was encouraged, which fosters a more dynamic and competitive business environment.

A Phoenix From The Ashes

These reforms, though initially met with challenges, gradually bore fruit. Exports grew, foreign investment increased, and the economy began to recover. By the mid-1990s, India emerged from the crisis stronger and more resilient.

Lessons Learned

The 1991 BOP crisis serves as a stark reminder of the importance of sound economic policies and a flexible approach to navigating external shocks. It also highlights the potential of bold reforms to unlock a nation's true economic potential.

INDIA'S BOP SITUATION POST-REFORMS (1991-PRESENT)

India's Balance of Payments (BOP) story since the 1991 reforms has been a tale of two halves: steady improvement followed by challenges in recent years. Let's delve into the factors behind this evolving landscape:

Positive Trends

- **Booming Invisibles:** The service sector, particularly software exports and private remittances from abroad, witnessed significant growth, generating valuable foreign exchange earnings.
- **NRI Deposits:** Special incentives by the Reserve Bank of India (RBI) attracted increased NRI deposits, bolstering the capital account.
- **Foreign Investment:** Foreign Direct Investment (FDI) and portfolio investments rose steadily, providing much-needed capital inflows.
- **Net External Commercial Borrowings (ECBs):** While ECBs initially increased, a negative net ECB in 2014-19 indicates a reduced reliance on external debt.

Challenges and Concerns

- **Rising Imports:** Increased demand, domestic price pressures, and large-scale development projects fueled a surge in imports, putting pressure on the current account deficit.
- **Capital Flow Obstacles:** Political instability and natural calamities could deter foreign investments, hindering capital inflows.

- **Currency Depreciation:** When imports exceed exports, the rupee can depreciate, further exacerbating the trade deficit.

Government and RBI Measures to Address BOP Imbalances

Maintaining a balanced Balance of Payments (BOP) is a delicate dance for any nation. When imbalances arise, the government and the Reserve Bank of India (RBI) have a toolbox of measures to help restore equilibrium. Let's explore the key tools they employ:

1. Credit Control Measures

- **Tightening monetary policy:** By raising interest rates or reducing bank reserves, the RBI can restrict the flow of credit in the economy. This reduces money supply, dampening demand for imports and potentially boosting exports.
- **Selective credit control:** The RBI can target specific sectors or activities with credit restrictions, further influencing imports and exports in targeted ways.

2. Exchange Rate Management

- **Devaluation:** A deliberate weakening of the domestic currency makes exports cheaper and imports more expensive, potentially tilting the balance in favor of exports. However, this can have inflationary consequences and should be used cautiously.
- **Flexible exchange rate policy:** Allowing the rupee to fluctuate more freely against other currencies can help absorb external shocks and adjust to changing market conditions.

3. Trade Policy Measures

- **Export Promotion:** Incentives like tax breaks, subsidies, and export financing schemes can encourage domestic producers to export more, boosting foreign currency earnings.
- **Import Control:** Imposing tariffs, quotas, or other restrictions on certain imports can discourage demand for non-essential goods and services, reducing the trade deficit.

4. Structural Reforms

- **Improving competitiveness:** Removing red tape, streamlining regulations, and investing in infrastructure can help domestic industries compete effectively in the global market, boosting exports.
- **Fiscal consolidation:** Reducing budget deficits and controlling government spending can free up resources for productive investments and improve investor confidence.

Major Items of India's Balance of Payments (US$ billion)

	April-June 2023 P			April-June 2022		
	Credit	Debit	Net	Credit	Debit	Net
A. Current Account	221.4	230.6	–9.2	231.0	249.0	–17.9
1. Goods	105.0	161.6	–56.6	122.8	185.9	–63.1
Of which:						
Petroleum, Oil and Lubricants (POL)	19.1	43.3	–24.3	26.9	53.2	–26.3
2. Services	80.6	45.4	35.1	76.1	45.0	31.1
3. Primary Income	8.7	19.3	–10.6	6.5	15.3	–8.9
4. Secondary Income	27.1	4.2	22.9	25.6	2.8	22.9
B. Capital Account and Financial Account	181.8	171.9	9.9	192.8	175.4	17.4
Of which:						
Change in Reserves [Increase (–)/Decrease (+)]	0.0	24.4	–24.4	0.0	4.6	–4.6
C. Errors and Omissions (–) (A + B)	0.0	0.7	–0.7	0.5	0.0	0.5
P. Preliminary						
Note: Total of sub-components may not tally with aggregate due to rounding off.						

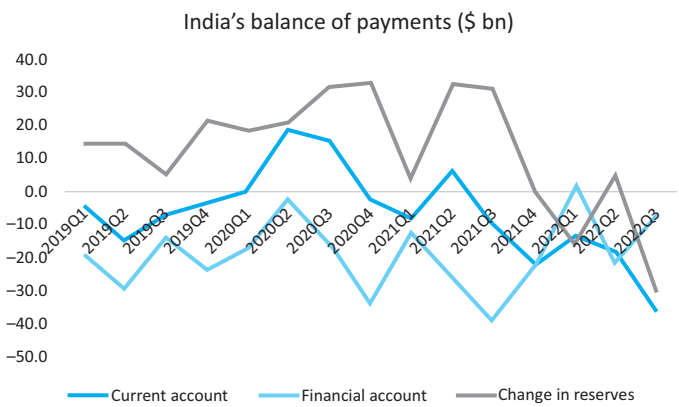


Fig. 11.14: India's balance of Payments ($bn)

The Dance of Twin Deficits: Understanding the Link Between Fiscal and Current Account Imbalances

The term "twin deficits" refers to a situation where a country simultaneously experiences both a fiscal deficit (government spending exceeds revenue) and a current account deficit (imports exceed exports).

The Twin Deficit Hypothesis

Proponents of the twin deficit hypothesis argue that large fiscal deficits can lead to increased borrowing, potentially pushing up interest rates and attracting foreign capital.

This influx of foreign funds can then drive up the exchange rate, making exports more expensive and imports cheaper, thereby contributing to a wider current account deficit. Additionally, government spending can stimulate aggregate demand, potentially leading to increased imports and further widening the current account gap.

Evidence in Support

- **United States:** The US has experienced persistent twin deficits for decades, with large fiscal deficits coinciding with significant current account imbalances.
- **India:** Similar patterns have been observed in India, where periods of fiscal deficits often correspond with wider current account deficits.

Challenging the Hypothesis

However, critics of the twin deficit hypothesis point to several counter-arguments:

- **Causality:** The correlation between fiscal and current account deficits doesn't necessarily imply causation. Other factors, such as exchange rate fluctuations and global economic conditions, can also play a significant role in shaping both deficits.
- **Example:** Countries like China, with long-term fiscal surpluses, have also experienced current account surpluses, suggesting that the link between the two deficits isn't absolute.
- **Policy Mix:** The impact of fiscal deficits on the current account depends on how the government finances its spending. Debt-financed spending might have a stronger impact compared to tax-financed spending.

The J-Curve: When Devaluation Takes a Winding Road

Imagine a country facing a trade deficit, where imports outweigh exports. To boost exports, they choose a bold path: devaluing their currency. But before you see sunshine and rainbows, prepare for a bumpy ride on the J-Curve.

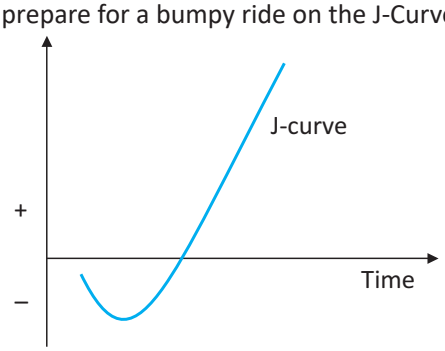


Fig. 11.15

Here's Why

- **The initial dip:** Devaluation makes imports expensive, discouraging domestic consumers from buying them. However, export prices become lower for foreign buyers, making them more attractive. This is the downward swing of the J, where the trade deficit actually widens in the short term.
- **The turnaround:** Gradually, the magic starts to work. As businesses realize their export goods are more competitive, production and export volumes begin to rocket. Domestic consumers, feeling the pinch of pricier imports, turn to domestically produced goods, further boosting local production. This is the upward swing of the J, where the trade deficit narrows and eventually transforms into a surplus.
- **The wait is worth it:** The entire journey can take months, even years, depending on factors like industry flexibility, trade agreements, and global market conditions. But if done right, devaluation can ultimately strengthen the balance of trade, leading to a smaller import bill and a bigger export boom.
- **Remember:** The J-Curve is a theoretical model, and its real-world application can be complex. Factors like inflation, domestic economic health, and external shocks can all influence the speed and shape of the curve.
- So, is devaluation the magic potion for every struggling economy? Not necessarily. It is a powerful tool, but like any potent medicine, it needs careful consideration and responsible implementation. Otherwise, the downward swing of the J might become a permanent nosedive.

International Investment Position (IIP)

- The IIP is periodically compiled by the Reserve Bank of India (RBI), typically every quarter.
- It is constructed through a comprehensive analysis of India's foreign assets and liabilities, drawing data from 13 different sources.

The IIP Provides a Snapshot of

- **Assets:** Everything India owns overseas, including investments in foreign companies, bonds, and of course, foreign exchange reserves. Imagine it as India's 'savings' abroad.
- **Liabilities:** What others owe India, such as foreign investments in Indian companies, loans, and derivatives. Think of it as India's 'debt' to the world.

The Net IIP: Now, Subtract India's liabilities from its assets, and you get the Net IIP. This number tells you, in a single glance, if India is a net creditor or debtor on the global stage.

Current Status: As of June 2020, India's Net IIP stood at a negative $345.7 billion. This means that India currently owes more to the world than it owns.

Why is IIP important?

- **Financial health:** It gives a clear picture of India's financial position relative to the rest of the world.
- **Investment climate:** Understanding IIP helps investors assess India's financial stability and attractiveness for investments.
- **Policymaking:** IIP data informs government policies on foreign exchange management, debt management, and economic growth strategies.

Significance of BoP in the Indian Economy

- **Impact on economic growth:** BoP imbalances can affect the availability of foreign exchange, influencing investment, imports, and economic activity.
- **Exchange rate stability:** A healthy BoP helps maintain a stable exchange rate, promoting trade and investment.
- **Debt sustainability:** Excessive reliance on foreign debt can create vulnerabilities and raise concerns about debt sustainability.
- **Foreign policy considerations:** BoP dynamics can be influenced by trade agreements, foreign policy decisions, and international economic conditions.
- **Promoting exports:** Increasing exports through various initiatives can improve the trade balance and reduce the CAD.
- **Attracting foreign investment:** Creating an investor-friendly environment and implementing reforms can attract foreign direct and portfolio investments.
- **Managing debt levels:** Maintaining a sustainable level of foreign debt and diversifying borrowing sources are crucial for financial stability.
- **Maintaining currency stability:** Implementing sound macroeconomic policies and managing foreign exchange reserves are essential for currency stability.

PURCHASING POWER PARITY (PPP): A LEVEL PLAYING FIELD FOR GLOBAL PRICES

Purchasing Power Parity (PPP) is a complex yet crucial concept in understanding the relative economic well-being of different countries. It goes beyond traditional measures like nominal GDP to compare living standards by adjusting prices for differences in the cost of living across nations.

Understanding the Concept

- Imagine a world where a cup of coffee costs the same, whether you're sipping it in a bustling London cafe or a sunny Mumbai street stall. That's the dream of Purchasing Power Parity (PPP): a theoretical framework that aims to equalise the prices of a basket of goods and services across different countries.

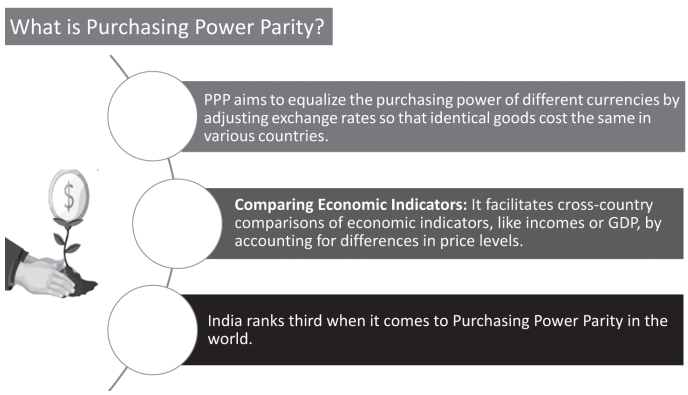

What is Purchasing Power Parity?
PPP aims to equalize the purchasing power of different currencies by adjusting exchange rates so that identical goods cost the same in various countries.
Comparing Economic Indicators: It facilitates cross-country comparisons of economic indicators, like incomes or GDP, by accounting for differences in price levels.
India ranks third when it comes to Purchasing Power Parity in the world.

Fig. 11.16: What is Purchasing Power Parity

- PPP is based on the "Law of One Price," which posits that, in a competitive market, freely traded goods and services should have the same price (adjusted for transportation costs) regardless of location.
- PPP calculations involve constructing a "basket" of goods and services representative of typical consumption patterns in different countries. The prices of these items in each country are then compared, and adjustments are made to reflect differences in purchasing power.

The Formula

To achieve this, PPP uses a relatively simple formula:

$$S = P_1 / P_2$$

- **S:** The exchange rate of currency 1 to currency 2 (e.g., USD/INR)
- **P_1:** The cost of a basket of goods and services in currency 1 (e.g., ₹ 500)
- **P_2:** The cost of the same basket in currency 2 (e.g., $10)

Example: Let's say a pair of jeans costs ₹ 2000 in India and $50 in the US. In a PPP world, the exchange rate should be:

$$S = ₹\ 2000 / \$50 = 40$$

This means that 40 Indian rupees would be equivalent to $1, making the jeans roughly the same price in both countries.

Benefits of PPP

- **Comparing living standards:** PPP can help us compare living standards across countries by adjusting for differences in price levels. This is especially useful for assessing economic development and poverty levels.
- **Guiding investments:** PPP can inform investment decisions by providing a more realistic picture of potential returns in different markets.
- **Understanding trade imbalances:** PPP can shed light on trade imbalances by revealing whether a country's exports are undervalued or overvalued compared to its imports.

Limitations of PPP

- **Difficult to measure:** Accurately measuring the cost of a basket of goods and services across different countries is a complex task, leading to potential inaccuracies in PPP calculations.
- **Assumption of identical preferences:** PPP assumes that consumers in different countries have the same preferences and consumption patterns, which is not always true.
- **Changes in exchange rates:** PPP is a static concept, while exchange rates constantly fluctuate. This can make it difficult to interpret PPP data over time.

Application of PPP in India

- India's PPP-adjusted GDP is significantly higher than its nominal GDP, indicating a lower cost of living and a higher standard of living compared to many other countries.

- PPP data is used by policymakers to assess India's global competitiveness and to target development programs towards sectors with high potential for growth.
- Indian businesses can leverage PPP data to identify promising markets for exports and to assess their relative cost advantages in different countries.
- **Note:** India ranks third when it comes to Purchasing Power Parity.
  - As per Purchasing Power Parity (PPP), an income of ₹ 23 lakh in India would equate to earnings of approximately Rs 65 lakh in the United Kingdom, ₹ 37 lakh in the UAE, and ₹ 79 lakh in the US.

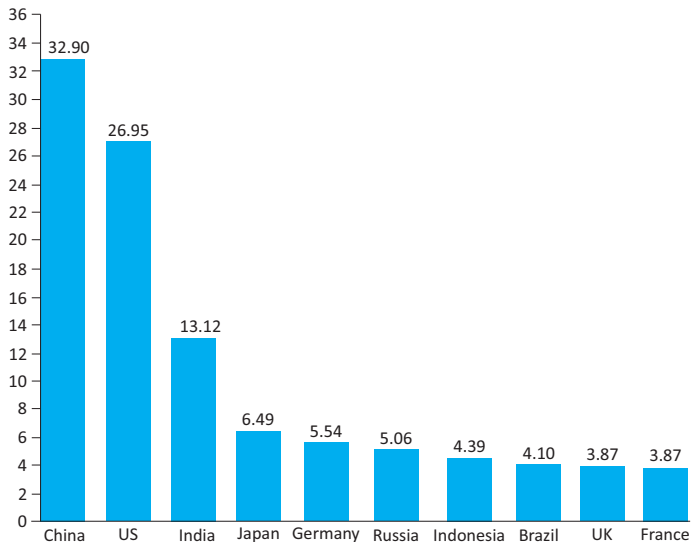


Fig. 11.17: Largest economies in the world by GDP (PPP) in 2023

What factors contribute to India's high ranking in PPP despite its lower GDP ranking?

India's ranking of 5th in GDP and 3rd in PPP presents a fascinating contrast and can be explained through several factors:

Nominal GDP

- Measured in current market exchange rates, nominal GDP reflects the total monetary value of all final goods and services produced in a country.
- India's large population (second highest in the world) translates to a significant size of its economy even with a relatively lower average income per capita.
- However, nominal GDP can be sensitive to fluctuations in exchange rates, making comparisons between countries less accurate.

Purchasing Power Parity (PPP)

- PPP adjusts for differences in price levels between countries, providing a more accurate comparison of living standards and economic well-being.
- PPP essentially converts all countries' currencies into a common "international dollar," reflecting the relative purchasing power of each currency within its own economy.
- India's relatively lower cost of living (compared to developed countries) means that the same amount of money can buy more goods and services in India than in many other countries, boosting its PPP ranking.

Reasons For The Difference

- **Large informal sector:** A significant portion of India's economy operates in the informal sector, which is often not captured in official GDP estimates. This underestimates the true size of the economy when measured in nominal terms.
- **Currency valuation:** The Indian rupee is relatively undervalued compared to some other major currencies. This means that Indian goods and services are cheaper in international markets, leading to higher exports and boosting PPP.
- **Differences in consumption patterns:** Consumption patterns often differ between countries. In Indita, a larger proportion of income is spent on basic necessities like food and shelter, which are typically cheaper than in developed countries. This contributes to a higher PPP ranking, even with lower overall income.

Implications

- While India's high PPP ranking indicates a relatively good standard of living for many of its citizens, it also highlights the wide income disparities within the country.
- The gap between nominal GDP and PPP ranking underscores the importance of adjusting for price levels when comparing economic performance across countries.
- Understanding these differences can help policymakers design effective strategies for economic development and poverty reduction.

EXCHANGE RATE

- The exchange rate refers to the valuation at which a country's native currency is traded against various international currencies, such as the US Dollar, within the global foreign exchange market.
- When countries trade goods and services, the value of their currencies relative to each other plays a critical role. This exchange rate can be set by the government (fixed) or determined by market forces (flexible), each approach with its own set of advantages and disadvantages.

Exchange Rates of Major Currencies with Indian Rupee (INR) as of October, 2023

Currency	Code	Exchange Rate (INR per Unit)
US Dollar	USD	83.2550
Euro	EUR	88.7825
British Pound	GBP	101.48
Japanese Yen	JPY	55.2300
Canadian Dollar	CAD	60.2550
Chinese Yuan	CNY	12.15

Fixed Exchange Rate System

Imagine a currency market where the government acts as the bouncer, **dictating the price at which you can exchange your rupees for dollars, euros, or any other currency.** This is the essence of a fixed exchange rate system.

Advantages

- **Stability and Predictability:** Businesses and investors appreciate knowing the exchange rate won't suddenly fluctuate, which makes it easier to plan and manage international transactions.
- **Encourages Foreign Investment:** Stable exchange rates can attract foreign investment, as investors feel more confident putting their money in a country with a predictable currency value.
- **Reduces Speculation:** With the government setting the price, there's less room for speculative trading, potentially leading to a more stable financial environment.

Disadvantages

- **Loss of Flexibility:** The government's grip on the exchange rate can hinder the economy's ability to adjust to external shocks like oil price increases or global financial crises.
- **Potential for Misalignment:** Over time, the government-determined rate might diverge from the market's natural equilibrium, leading to overvaluation or undervaluation of the currency, harming international trade.
- **Burden on Reserves:** Maintaining a fixed rate can deplete the government's foreign exchange reserves, especially during periods of sustained pressure on the currency.

Flexible (Floating) Exchange Rate System

Unlike a bouncer, a flexible exchange rate system lets the market forces of supply and demand determine the value of currencies. Think of it as a currency auction, where **the highest bidder gets the best exchange rate.**

Advantages

- **Automatic Adjustment:** The exchange rate automatically adjusts to changing economic conditions, allowing the economy to adapt to external shocks more efficiently.
- **Resource Allocation:** By reflecting the true value of the currency, a flexible system can encourage efficient allocation of resources in the economy.
- **Promotes International Capital Flow:** Free movement of capital across borders is facilitated, potentially boosting economic growth and development.

Disadvantages

- **Volatility and Uncertainty:** Businesses and investors face greater uncertainty due to fluctuating exchange rates, making it challenging to plan and manage international transactions.
- **Speculative Pressure:** Flexible systems can be susceptible to speculative attacks, leading to sudden and potentially destabilising swings in the currency value.
- **Potential for Inflation:** Exchange rate fluctuations can impact import prices, potentially leading to inflation if not managed effectively.

Choosing the Right System

The optimal exchange rate system for a country depends on its unique economic and financial conditions, priorities, and risk tolerance. Emerging economies often start with fixed or pegged systems for stability and attract investment, and later transition to more flexible regimes as they mature. Ultimately, the goal is to find a system that balances the need for stability with the flexibility to adapt to an ever-changing global economic environment.

Difference between Fixed Exchange Rate and Flexible (floating) Exchange Rate

Feature	Fixed Exchange Rate	Flexible (Floating) Exchange Rate
Mechanism	Government sets and maintains a pre-determined exchange rate for the domestic currency against a foreign currency or basket of currencies.	Market forces of supply and demand determine the exchange rate.
Stability & Predictability	High. Businesses and investors can plan with certainty knowing the exchange rate won't fluctuate significantly.	Low. Businesses and investors face uncertainty due to potential for fluctuations.
Flexibility	Low. The economy has limited ability to adjust to external shocks.	High. The exchange rate automatically adjusts to changing economic conditions.
Foreign Investment	Can attract foreign investment due to stability and predictability.	May discourage foreign investment due to uncertainty.

Feature	Fixed Exchange Rate	Flexible (Floating) Exchange Rate
Resource Allocation	May not reflect the true value of the currency, leading to inefficient resource allocation.	Reflects the true value of the currency, potentially leading to efficient resource allocation.
International Capital Flow	Restricted due to government controls	Free movement of capital across borders.
Government Intervention	High. The government actively intervenes in the market to maintain the fixed rate.	Low. The government usually only intervenes to smooth out excessive volatility.
Advantages	Predictability, encourages foreign investment, reduces speculation.	Automatic adjustment, efficient resource allocation, promotes capital flow.
Disadvantages	Loss of flexibility, potential for misalignment, burden on reserves.	Volatility and uncertainty, potential for speculative attacks, inflationary pressure.
Best suited for	Developing economies seeking stability and attracting investment, countries with strong currencies.	Developed economies with flexible economies, countries comfortable with uncertainty.

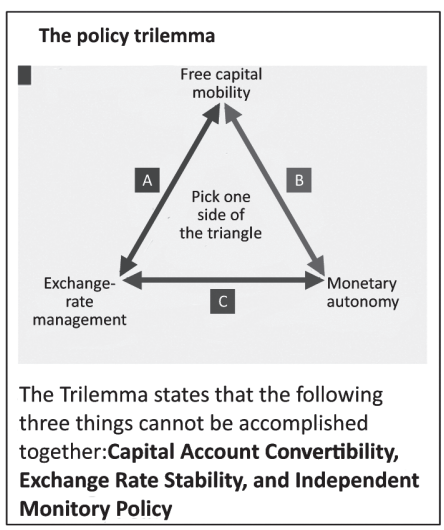
The Evolution of Exchange Rate Systems in India

India's exchange rate system has undergone a fascinating transformation since its independence, reflecting its evolving economic landscape.

- **1947-1971: The Era of the Fixed Peg:**
  - **Bretton Woods System:** As a founding member of the International Monetary Fund (IMF), India adopted the fixed peg system prescribed by the Bretton Woods Agreement. The rupee was tied to the US dollar, which held a fixed gold value. This system offered stability and predictability for international trade.
- **1971-1975: Shifting Anchor amid Global Change:**
  - **Unmooring from the Dollar:** With the collapse of the Bretton Woods system in 1971, the US dollar's convertibility to gold was suspended. India, then, temporarily switched its peg to the British pound sterling, seeking a new anchor for stability.
- **1975-1992: Embracing a Basket of Options:**
  - **Currency Diversification:** Recognizing the limitations of single currency pegging, India adopted a basket peg system in the 1970s and 1980s. This system linked the rupee to a basket of currencies, offering greater flexibility and resilience to external shocks.
- **1992-1993: Navigating Crisis with a Dual Approach:**
  - **LERMS and the Dual Rate:** Facing a severe balance of payments crisis in 1992, India implemented the Liberalised Exchange Rate Management System (LERMS). This system introduced a dual exchange rate, with 40% of export earnings channelled through a fixed official rate and 60% subject to market forces. However, this system proved unpopular with exporters.
- **1993 Onwards: Embracing the Flexibility of Managed Float:**
  - **Unified Exchange Rate System and Managed Float:** Recognizing the limitations of LERMS, India transitioned to a Unified Exchange Rate System (UERS) in 1993. This system allowed for 100% market-determined exchange rates, marking a shift towards a managed float regime. This system offered greater flexibility for businesses and investors, while allowing the central bank to intervene in times of excessive volatility.

Which System Will Suit Indian Economy Best?

Determining the ideal exchange rate system for a complex and diverse economy like India is no simple task. Both fixed and flexible systems offer advantages and drawbacks, and the optimal approach lies in finding a balanced solution that aligns with India's specific economic goals and vulnerabilities.



The Trilemma states that the following three things cannot be accomplished together:**Capital Account Convertibility, Exchange Rate Stability, and Independent Monitory Policy**

Fig. 11.18: Mundell Fleming Trilemma

Arguments For Fixed Exchange Rate

- **Stability and Predictability:** A fixed exchange rate can foster investment and trade by providing businesses with a predictable environment for planning and transactions. This can be particularly beneficial for India's growing domestic market and its aspirations to attract foreign investment.

- **Export Competitiveness:** Pegging to a stronger currency like the US dollar can make Indian exports cheaper in the international market, potentially boosting export growth.
- **Inflation Control:** A fixed exchange rate can act as an anchor for inflation by limiting the impact of imported price pressures. This can be attractive for India, which has historically struggled with inflation.

Arguments For Flexible Exchange Rate

- **Automatic Adjustment:** A flexible exchange rate can automatically adjust to external shocks, such as changes in global commodity prices or capital flows. This provides the economy with a built-in shock absorber, which can be crucial for a country like India that is vulnerable to external factors.
- **Resource Allocation:** A flexible exchange rate reflects the true value of the currency, which can promote efficient allocation of resources in the economy. This can be crucial for India's long-term development goals.
- **Monetary Policy Autonomy:** A flexible exchange rate gives the central bank greater freedom to conduct independent monetary policy, allowing it to focus on domestic economic objectives like inflation and unemployment.

India's Current System: Managed Float

Recognizing the limitations of both fixed and flexible systems, India currently employs a managed float system. This system allows the exchange rate to fluctuate within a band but allows the central bank to intervene in the market to smooth out excessive volatility or prevent speculative attacks. This approach offers a balance between the stability of a fixed system and the flexibility of a free float.

Future Considerations

As India's economy continues to grow and evolve, the optimal exchange rate system may need to adapt as well. Key considerations for the future include:

- **Capital Account Liberalisation:** As India opens up its capital markets further, the pressure for a more flexible exchange rate may increase.
- **Global Economic Integration:** India's increasing integration with the global economy necessitates a system that can handle external shocks effectively.
- **Domestic Economic Stability:** Maintaining macroeconomic stability, particularly inflation control, remains crucial for any exchange rate system to be successful.

Difference Between Depreciation and Devaluation

Feature	Depreciation	Devaluation
Definition	Fall in the value of domestic currency relative to foreign currencies due to market forces (supply and demand).	Deliberate decrease in the value of domestic currency by the government.
Mechanism	Automatic adjustments based on market forces.	Official announcement and policy changes by the government.
Exchange Rate System	More common in flexible systems	More common in fixed systems
Impact on Trade Balance	Supply and demand forces in the foreign exchange market	Government intervention through policy changes
Impact on Inflation	Can lead to higher inflation due to more expensive imports.	Can lead to higher inflation if not managed carefully.
Overall Impact	Can be positive or negative depending on economic conditions	Primarily used to improve trade balance and boost exports, but can have negative consequences if not managed carefully.

Difference Between Depreciation and Appreciation

Feature	Depreciation	Appreciation
Definition	Decrease in the value of domestic currency relative to foreign currencies.	Increase in the value of domestic currency relative to foreign currencies.
Exchange Rate System	More common in flexible systems.	More common in flexible systems.
Impact on Imports	Makes imports more expensive.	Makes imports cheaper.
Impact on Exports	Makes exports cheaper (potentially boosting competitiveness).	Makes exports more expensive (potentially hurting competitiveness).
Overall Impact	Can be positive or negative depending on economic conditions (e.g., boosts exports in export-oriented economies, hurts consumer spending in import-dependent economies).	Can be positive or negative depending on economic conditions (e.g., promotes domestic industry, discourages tourism).

Is Currency Devaluation a Common Strategy Employed by Less Developed Countries For Economic Development?

Yes, it is true that less developed countries (LDCs) often devalue their currencies. There are several reasons for this:

- **Boost exports:** By making domestic goods and services cheaper in foreign markets, devaluation can make them more competitive and lead to an increase in exports. This can help LDCs earn more foreign exchange, which can then be used to import essential goods and services.
- **Attract foreign investment:** A weaker currency can make it cheaper for foreign companies to invest in LDCs. This can lead to increased investment in infrastructure, manufacturing, and other sectors, which can boost economic growth.
- **Reduce trade deficits:** If a country's imports are significantly higher than its exports, it has a trade deficit. Devaluation can help to reduce this deficit by making exports more competitive and imports more expensive.
- **Improve the current account balance:** The current account balance is a measure of a country's overall trade and investment flows. A devaluation can help to improve the current account balance by increasing exports and reducing imports.
- **Manage external debt:** Devaluation can make it cheaper for LDCs to repay their external debt, as the amount of domestic currency needed to service the debt will decrease.

However, Devaluation Also has Some Drawbacks

- **Increase inflation:** A weaker currency can make imported goods and services more expensive, which can lead to higher inflation. This can put a strain on consumers and businesses alike.
- **Reduce confidence in the currency:** Devaluation can erode confidence in the currency, which may lead to capital flight and further depreciation.
- **Hurt domestic industries:** Some domestic industries, such as those that rely on imported inputs, can be hurt by devaluation.
- **Create uncertainty:** Devaluation can create uncertainty in the economy, which can discourage investment and economic growth.
- Overall, the decision of whether or not to devalue a currency is a complex one that should be made on a case-by-case basis. There are both potential benefits and drawbacks to consider, and the best course of action will depend on the specific circumstances of the country.

Here are Some Examples of LDCs That Have Devalued Their Currencies in Recent Years

- **India:** In 1991, the Indian government devalued the rupee by 18% to 19% in order to overcome a balance of payments crisis.
- **Brazil:** In 1999, the Brazilian government devalued the real by 30% in order to boost exports and attract foreign investment.
- **Argentina:** In 2001, the Argentine government devalued the peso by 70% in order to deal with a severe economic crisis.

NEER VS. REER: THE YARDSTICKS FOR CURRENCY VALUATION

Understanding the relative value of a currency is crucial in today's interconnected world. Two key tools in this endeavor are the **Nominal Effective Exchange Rate (NEER)** and the **Real Effective Exchange Rate** (REER).

Nominal Effective Exchange Rate (NEER)

- Imagine a basket overflowing with different foreign currencies. The NEER tells you how much of your local currency you need to swap for that entire basket – a single, weighted average that captures your currency's overall strength against a bunch of rivals.
- Unlike the individual exchange rate for each currency, the NEER paints a broader picture, showing how your currency fares in the international market. It is like a champion competing in a multi-country tournament, not just one-on-one duels.
- So, remember, the NEER is like a multidimensional lens, revealing your currency's position in the global market compared to various competitors. It is a tool for understanding your country's trade competitiveness and making informed economic decisions.

Real Effective Exchange Rate (REER)

NEER tells you the relative purchasing power of your currency, but it doesn't account for inflation differences. REER takes this a step further by adjusting NEER for inflation in both your country and your trading partners. This provides a more accurate picture of your currency's purchasing power across borders.

Recent Data For India

- **NEER (Feb 2023):** 104.74 (Source: Reserve Bank of India)
- **REER (Jan 2023):** 113.16 (Source: Reserve Bank of India)
- **Note:** A rising NEER indicates a stronger currency in nominal terms, meaning you can buy more foreign goods with your currency.
- **Note:** A rising REER implies a stronger currency in real terms, meaning your purchasing power increases relative to your trading partners.

Difference Between NEER and REER

NEER (Nominal Effective Exchange Rate)	REER (Real Effective Exchange Rate)
Represents the nominal value of a country's currency against a basket of foreign currencies.	Adjusted to account for inflation differences between the home country and its trading partners.
Evaluates a currency's strength based on nominal exchange rates with multiple foreign currencies.	Offers a more accurate reflection of a currency's purchasing power by considering inflation rates.
Considers only nominal exchange rates.	Factors in both nominal exchange rates and relative price changes due to inflation.
Measures competitiveness in the foreign exchange market.	Provides a more realistic assessment of a currency's actual value in terms of purchasing power.

Decoding the Power of NEER and REER: Why They Matter in Global Trade?

In the intricate world of international trade, NEER and REER are not just acronyms, but powerful tools that illuminate a nation's economic health and competitive edge. Let's dive into their significance:

Exchange Rate X-Ray

- Imagine a doctor examining an X-ray to diagnose a bone fracture. NEER and REER act like X-rays for a country's currency, revealing its relative strength or weakness against a basket of trading partners' currencies.
- NEER provides a snapshot of the current exchange rate landscape, highlighting how much home currency you need to buy each foreign currency. Higher NEER means a stronger home currency, potentially making imports expensive and exports less competitive.
- REER adjusts for inflation differences between the home country and its trading partners. This unveils the true competitiveness of exports, as a higher REER signifies they become relatively more expensive in the global market.

Policy Powerhouse

- NEER and REER aren't just passive observers; they're policy powerhouses. Governments and central banks leverage these insights to formulate effective exchange rate strategies.
- A rapidly appreciating NEER might trigger intervention to curb its strength and protect export competitiveness. Conversely, a depreciating NEER could prompt measures to attract foreign investment and boost exports.

Trade and Balance Maestro

- NEER and REER are the maestros of the trade and balance of payments orchestra. They provide a comprehensive view of a country's trade position, considering both nominal and real exchange rates.
- A rising NEER might indicate a widening trade deficit, prompting policymakers to analyze the underlying causes and implement corrective measures. REER, on the other hand, can reveal whether this deficit is due to genuine competitiveness issues or simply currency fluctuations.

Macroeconomic Microscope

- NEER and REER don't operate in isolation; they're crucial for understanding the broader macroeconomic picture. They act as microscopes, revealing the impact of exchange rate fluctuations on critical variables like inflation, interest rates, investment, and economic growth.
- A persistently strong NEER could lead to lower inflation but also dampen export growth. Conversely, a depreciating NEER might boost exports but fuel inflationary pressures.

FOREIGN EXCHANGE REGULATION ACT (FERA) AND FOREIGN EXCHANGE MANAGEMENT ACT (FEMA)

The Government of India introduced two acts pertaining to foreign exchange: FERA in 1973 and FEMA in 1999, with FEMA subsequently replacing FERA

Foreign Exchange Regulation Act (FERA)

The Indian economy's integration with the global financial system necessitates a robust regulatory framework to manage foreign exchange flows. The Foreign Exchange Regulation Act (FERA), enacted in 1973, serves as the cornerstone of this framework, aiming to maintain stability and promote orderly development of the foreign exchange market.

Key Aspects of FERA

- **Centralized Control:** FERA empowers the Reserve Bank of India (RBI) with broad oversight and control over foreign exchange transactions. This ensures a unified approach to managing the forex market and preventing potential imbalances.

- **Restrictions on Transactions:** FERA regulates specific transactions involving foreign exchange, including inflows, outflows, and domestic holdings. It sets limits on foreign investments, remittances, and foreign currency holdings by Indian residents.
- **Exchange Rate Management:** FERA empowers the RBI to manage the exchange rate regime, enabling it to intervene in the market to maintain stability and prevent excessive volatility. This flexibility allows for adjustments based on changing economic conditions.
- **Compliance and Enforcement:** FERA outlines stringent compliance requirements for individuals and entities involved in foreign exchange transactions. The RBI has the authority to investigate and penalize non-compliance, ensuring adherence to the regulations.

FERA's Impact on the Indian Economy

- **Promoting Stability:** FERA's centralized control fosters stability and predictability in the forex market, attracting foreign investments and facilitating international trade.
- **Preventing Currency Fluctuations:** The RBI's ability to manage the exchange rate under FERA helps mitigate excessive volatility in the currency market, protecting domestic businesses and consumers from unpredictable financial shocks.
- **Balancing Capital Flows:** FERA's regulations on foreign investments and remittances help manage the inflow and outflow of foreign capital, ensuring that these flows do not disrupt the domestic financial system.

What were Some Issues with Fera Because of Which Government had to Bring FEMA in 1999?

Several issues plagued the Foreign Exchange Regulation Act (FERA), necessitating the introduction of the Foreign Exchange Management Act (FEMA) in 1999. Here are some key problems with FERA:

- **Excessive Rigidity:** FERA was a highly restrictive act, imposing tight controls on foreign exchange transactions and investments. This stifled economic growth and discouraged foreign investment, hindering India's potential for integration with the global market.
- **Black Market Boom:** The strict regulations of FERA led to the flourishing of a black market for foreign exchange. This undermined the official exchange rate system and created opportunities for illicit activity and corruption.
- **Bureaucratic Bottlenecks:** FERA's complex procedures and bureaucratic approvals added unnecessary layers of paperwork and delays to legitimate transactions, further discouraging foreign investment and trade.
- **Limited Access to Global Opportunities:** Indian individuals and businesses were significantly restricted in their ability to invest abroad and participate in international financial markets under FERA, limiting their growth and diversification potential.
- **Inability to Respond to Liberalization:** As India's economy liberalized in the 1990s, FERA's outdated framework became increasingly unsuitable. It lacked the flexibility to adapt to the changing needs of the market and the growing integration of India's economy with the global system.

Foreign Exchange Management Act (FEMA)

Imagine a vigilant gatekeeper ensuring the smooth flow of money across borders. That's the role of the Foreign Exchange Management Act (FEMA), India's guardian of financial transactions with the outside world.

Born in Liberalization

Enacted in 1999, FEMA replaced the archaic Foreign Exchange Regulation Act, reflecting India's shift towards economic liberalization. Its core mission? To facilitate external trade and payments and promote a healthy foreign exchange market.

Key Pillars of FEMA

- **Authorized Dealers:** FEMA empowers banks and other institutions to act as authorized dealers, enabling them to handle foreign exchange transactions on behalf of individuals and businesses.
- **RBI's Watchful Eye:** The Reserve Bank of India (RBI) acts as the conductor of the foreign exchange orchestra. FEMA grants it the power to regulate transactions, monitor compliance, and provide stability to the market.
- **Global Opportunities for Indians:** Indian nationals can now legally own property abroad (acquired during travel or through inheritance) and participate in certain types of foreign exchange trading, opening doors to global financial involvement.
- **Transaction Transparency:** FEMA lays down detailed guidelines for foreign exchange transactions, including remittances, travel allowances, and current account activities. This ensures transparency and reduces the risk of misuse.

Regulations and Penalties

- **Limits and Checks:** To maintain stability, FEMA sets limits on specific transactions, with hefty penalties for exceeding them. Penalties can involve fines, property confiscation, and even daily charges.
- **Compliance is Key:** Businesses and individuals engaging in foreign exchange transactions must adhere to FEMA regulations to avoid legal repercussions.

FEMA's Impact

- **Boosted Trade and Investment:** By simplifying foreign exchange transactions, FEMA has facilitated international trade and attracted foreign investment into India, ultimately contributing to economic growth.

- **Financial Stability:** Strong regulations have prevented currency manipulation and protected India's foreign exchange reserves, ensuring a stable financial environment.
- **Global Integration:** FEMA has opened doors for Indian individuals and businesses to participate in the global financial landscape, paving the way for greater economic integration.

Difference Between FERA and FEMA

Aspect	FERA	FEMA
Year	Enacted in 1973	Enacted in 1999
Purpose	Regulated foreign exchange	Focuses on management and regulation of forex
Offenses	Strict regulations and penalties	Liberalized norms with lesser penalties
Repatriation	Restrictions on repatriation of funds.	Eased repatriation norms for foreign investments
Regulatory Body	Controlled by the Directorate of Enforcement (DOE)	Governed by the Reserve Bank of India (RBI) and the Foreign Exchange Management Act Authority (FEMA)

EXTERNAL COMMERCIAL BORROWINGS (ECBS)

Imagine a world where Indian companies can tap into cheaper international loans to pay for imports and fuel their growth. That's the promise of External Commercial Borrowings (ECBs), a crucial aspect of India's foreign exchange and trade reforms.

Key Features

- **Purpose of ECBs:** ECBs serve as a mechanism for Indian corporations to acquire funds in foreign currency from non-resident foreign lenders.
- **Nature of Borrowing:** Essentially, ECBs represent loans obtained by Indian companies from foreign entities outside the country.
- **Borrowing Sources:** Typically, companies secure ECBs through foreign commercial banks and other offshore institutions.
- **Utilization of Funds:** These funds acquired through ECBs can be utilized by Indian corporations to expand their current capacities or for new investment ventures.
- **Interest Rates and Mark-up:**
  - Interest rates on ECBs are connected to the London Inter-bank Offer Rate (LIBOR), a global benchmark for interest rates in which banks lend to each other.
  - Mark-up over LIBOR is typically in 'basis points' (bps), denoting additional percentage points over LIBOR.
    - However, LIBOR has now been largely abandoned and replaced by the Secured Overnight Financing Rate (SOFR) and other benchmarks
  - Sovereign and corporate ratings assigned by international agencies like Moody's, Standard & Poor, and Fitch determine the mark-up.
- **Rating Scale and Impact:**
  - Ratings categorize economies as 'investment' or 'speculative' grade based on objective parameters.
  - Higher ratings denote lower risk, resulting in lower mark-ups; lower ratings incur higher risk and thus higher mark-ups.
- **Factors Influencing India's Rating:**
  - High fiscal deficit, exceeding 10% between central and state governments.
  - Elevated public debt ratio to GDP, surpassing 70%.
  - Comparative situations to historical financial crises in countries like Greece and Ireland.
  - Insufficient fiscal consolidation and a slowdown in the reform process.

Note:

- Under FEMA the Reserve Bank of India (RBI) allows automatic ECBs up to USD 750 million, with specific maturity periods and end-use restrictions.
- Currently, an overall country ceiling of USD 35 billion exists for ECBs, ensuring responsible borrowing.

Routes of ECB

- **Automatic Route:** Companies meeting the government's specified criteria can raise funds without requiring prior approval.
- **Approval Route:** Certain sectors necessitate government permission before undertaking ECB borrowings.

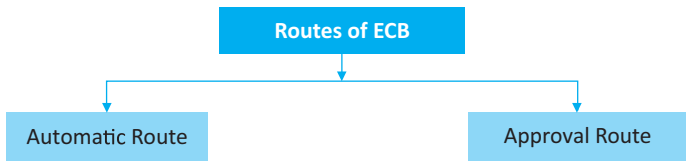


Fig. 11.19: Routes of ECB

Advantages of ECB

- **Large Long-Term Funding:** ECB offers access to substantial funds for extended durations.
- **Cost Efficiency:** Borrowing from economies with lower interest rates often results in cheaper funding.
- **Diversification of Investors:** It allows diversification of the investor base, broadening the funding sources.

Note:

Maturity: Minimum of 3 years for loans secured through ECBs.

Regulation: Ministry of Finance's Department of Economic Affairs and RBI jointly oversee and regulate ECB guidelines and regulations.

Debt Composition: Majority of India's external debt stems from commercial borrowings.

Currency Domination: USD remains the primary currency for external debt.

Disadvantages of ECB

- **Risk of Over-Borrowing:** Companies might borrow excessively, leading to increased debt on their balance sheets, potentially impacting financial health.
- **Negative Rating Impact:** Higher debt levels can cause negative perceptions from rating agencies, possibly resulting in market downgrades.
- **Foreign Currency Exposure:** Borrowing in foreign currencies exposes companies to exchange rate risks when repaying both principal and interest amounts.
- Only well-established companies can access the attractive rates offered by ECBs, leaving smaller players at a disadvantage.
- ECBs contribute to the country's external debt, adding another layer of economic consideration.

Way Forward

Improving India's sovereign rating through fiscal consolidation and reform acceleration should lead to lower ECB mark-up rates, boosting corporate competitiveness.

Expanding access to ECBs for smaller companies could further fuel growth and diversify the borrowing landscape.

CONVERTIBILITY

Imagine a world where exchanging rupees for dollars or euros is as easy as swapping shoes with a friend. That's the dream of currency convertibility, and India's rupee is inching closer to making it a reality. Convertibility simply means the ability to freely exchange one currency for another at market-determined rates. This opens doors for both individuals and businesses, facilitating international trade, investments, and travel.

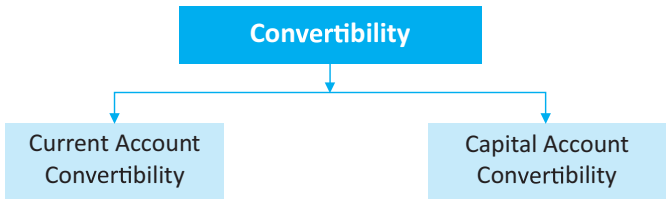


Fig. 11.20: Convertibility

Current Account Convertibility

- Ability to convert rupees for transactions related to trade and services (imports, exports, tourism).
- Fully convertible since 1994 as per IMF Article VIII obligations.
- Promotes foreign trade and investment by facilitating cross-border transactions.

Capital Account Convertibility

- Freedom to convert rupees for financial investments (e.g., portfolio investments, foreign direct investment).
- Partially convertible due to restrictions and regulations by the RBI and GOI.
- Prior approval required for certain transactions.

The Rupee's Path to Openness

India has been gradually liberalizing its capital account since the early 1990s. Tarapore Committees I and II were set up and submitted it's report 1997 and 2006, respectively, to suggest roadmaps for full convertibility, but their recommendations are yet to be fully implemented.

Why the Partial Approach?

Full convertibility can be a double-edged sword. While it allows for greater freedom and potential economic growth, it also makes the rupee more susceptible to external shocks and capital flight. The government and RBI are cautiously navigating the challenges to ensure a smooth transition.

Benefits of Full CAD

- Increased foreign investment and access to global capital markets.
- Boosted economic growth through enhanced efficiency and competition.
- Greater diversification of financial assets for Indian investors.

Challenges of Full CAD

- Potential for volatility in the rupee and financial markets.
- Risk of short-term capital outflows and financial instability.
- Need for robust regulatory frameworks to manage risks.

Difference between Current Account Convertibility and Capital Account Convertibility

Current Account Convertibility	Capital Account Convertibility
Involves the freedom to convert or exchange domestic currency for foreign currency concerning trade in goods and services, remittances, and short-term capital flows.	Encompasses the freedom to convert or exchange domestic currency for foreign currency concerning long-term capital flows, including investments, loans, and financial assets.
Aimed at facilitating international trade and transactions.	Intended to enable international investments and financial transactions.
Generally, more widely implemented across various economies.	Usually subject to stricter regulations and limitations due to its impact on a country's economy and financial stability.
Allows for easier cross-border transactions related to trade, services, and short-term capital movements.	Involves the conversion of domestic currency for investments, assets, and long-term financial commitments.
Examples include transactions in imports, exports, remittances, and tourism.	Examples include foreign direct investment (FDI), foreign institutional investments (FII), and long-term loans.

Rupee Convertibility: Open for Most, Closed for a Few

India embraces convertibility for most current account transactions, making it easy to exchange rupees for foreign currency and vice versa for everyday needs. However, some exceptions exist:

Restricted Activities

- **Gambling Windfalls:** Prizes from game shows, lotteries, racing, and betting? Hold on, those rupee-to-foreign currency conversions are off-limits.
- **Artistic Endeavors:** Paying foreign or Indian artists in foreign currency? You'll need the Ministry of Finance's green light.

Note:

- These restrictions aim to prevent misuse of foreign exchange and ensure responsible financial flows.
- For most regular transactions, like paying for imports or receiving remittances, convertibility is smooth and straightforward.

Limited Amounts

- **Travel:** Indian tourists converting more than $10,000 need a nod from the RBI (Reserve Bank of India).
- **Education and Medical:** Sending over $1 lakh for education or medical expenses? Get that RBI approval first.

Full Rupee Capital Account Convertibility: A Balancing Act of Potential Benefits and Limitations

The full convertibility of the Indian rupee is a complex and often debated topic. While it presents several potential benefits, it also comes with limitations that need careful consideration. Let's delve into both sides of the coin:

Potential Benefits

- **Increased foreign investment:** A fully convertible rupee could attract more foreign investors by offering them greater flexibility and ease of movement of their capital. This can lead to:
  - **Faster economic growth:** Increased investments can fuel infrastructure development, technology advancements, and job creation, propelling economic growth.
  - **Improved employment and business opportunities:** With more investment, companies can expand, creating new jobs and boosting the overall business environment.
- **Larger and more liquid financial markets:** A fully convertible rupee allows for greater participation of foreign players in Indian financial markets. This can:
  - **Increase liquidity:** More funds flowing in and out of the market can enhance its depth and efficiency.
  - **Improve financial innovation:** Exposure to global practices and expertise can drive innovation in financial products and services.
  - **Boost access to capital:** Indian companies and individuals may gain easier access to foreign capital for investments and growth.
- **Progress in multiple sectors:** Increased foreign investment and access to technology can lead to advancements in various industries like healthcare, education, and manufacturing, contributing to overall development.

Limitations and Concerns

- **Exposure to global vulnerabilities:** A fully convertible rupee makes the Indian economy more susceptible to global financial shocks and crises. This could lead to:
  - **Volatility in exchange rates:** Sudden changes in global market sentiment can cause rapid fluctuations in the rupee's value, impacting trade and investments.
  - **Capital flight:** Investors may choose to withdraw their funds quickly during times of economic uncertainty, leading to a liquidity crunch and potential financial instability.

- **Risk of speculative attacks:** A fully convertible rupee could be targeted by speculators seeking to profit from its depreciation. This can lead to artificially induced currency fluctuations and market instability.
- **No ceiling on external debt:** The Indian government might be tempted to borrow heavily in foreign currency if there is no limit on external debt. This can lead to a debt trap and hinder future economic growth.
- **Contagion effect:** Financial crises in other countries can easily spread to India through interconnected markets, potentially causing domestic instability.

Pre-conditions and Considerations

The Tarapore Committee, a government-appointed body, outlined several pre-conditions for full rupee convertibility, including:

- Fiscal deficit below 3.5% of GDP
- Stronger financial sector
- Reduced public debt
- Inflation target within 3-5%
- Adequate foreign exchange reserves

These pre-conditions are crucial to ensure that the Indian economy is robust enough to withstand the potential risks of full convertibility.

INTERNATIONALIZATION OF THE INDIAN RUPEE: OPPORTUNITIES AND CHALLENGES

The Indian rupee's internationalization has been a long-held dream for India, aiming to boost its economic clout and global presence. But what exactly does it mean for the rupee to be "internationalized"?

Key Indicators of an Internationalized Rupee

- **Widespread Acceptance:** Banks, firms, and individuals beyond India actively hold rupees for financial security and investment purposes.
- **Trade Currency:** The rupee becomes a preferred currency for settling international trade transactions, reducing reliance on foreign currencies like the US Dollar.
- **Investment Magnet:** Non-resident investors actively seek rupee-denominated assets like bonds and securities, attracted by India's economic prospects.

Prerequisites for Internationalisation

- **Sufficient Availability:** Enough rupees must be readily available in the global financial system to meet demand.
- **Currency Stability:** A stable and predictable rupee exchange rate fosters confidence among international users.
- **Liquidity:** Easy and efficient exchange of rupees for other currencies is crucial for smooth international transactions.

Current International Currency Landscape

Currently, currencies like the US Dollar, Euro, Pound Sterling, Japanese Yen, and Chinese Renminbi dominate global markets due to their established presence and strong economies.

Internationalization of Indian Rupee

Current status

Currency	Share in Global Forex Reserves (Economic Survey 2023)
US $	88%
INR	1.6%
Minimum percentage required to be called 'international currency'	4% (as per ES23)

India's Steps towards Rupee Internationalisation

- **Nepal and Bhutan:** These countries hold the rupee alongside their own currencies for financial security and cross-border trade, showcasing regional acceptance.
- **Capital Account Convertibility Relaxation:** Loosening restrictions on foreign investment in rupee-denominated assets is key to attracting international investors.
- **Masala Bonds:** Issuing rupee-denominated bonds abroad, like the International Finance Corporation's Masala Bonds, enhances the rupee's visibility and accessibility.

Potential Benefits of Rupee Internationalisation

- **Forex Savings:** Reduced dependence on foreign currencies in international transactions can conserve valuable foreign exchange reserves.
- **Trade Boost:** Increased use of the rupee for trade can improve India's bargaining power and reduce transaction costs.
- **Capital Flow Improvement:** Attracting foreign investment can accelerate economic growth and development.

Challenges and Concerns

- **India's Share in Global Trade:** Currently, India's share in global trade is relatively small, which needs to be addressed for wider adoption of the rupee.
- **Currency Stability:** Maintaining a stable and predictable exchange rate remains crucial for attracting international trust.
- **Competition from Established Currencies:** Breaking into the dominance of established international currencies like the US Dollar will be a long-term process.

CURRENCY SWAP: A FINANCIAL HANDSHAKE ACROSS BORDERS

Imagine two friends, Alice and Bob, living in different countries with different currencies. Alice needs Yen for her vacation to Japan, while Bob needs Euros for his business trip to France. Instead of exchanging money at the airport, they decide on a "currency swap."

Here's How it Works

- Alice lends Bob an equivalent amount of Euros in exchange for Yen.
- Bob does the same for Alice, swapping his Yen for Euros.
- Both agree on a specific date and exchange rate to reverse the swap.

This is a bilateral currency swap, a financial agreement where two parties exchange identical sums of money in different currencies. It is like a friendly loan between countries, with the central banks acting as middlemen.

Why do Countries do This?

- **Hedge against exchange rate fluctuations:** If Alice expects the Euro to weaken, she can swap it for Yen now, locking in a favourable rate before it drops.
- **Reduce borrowing costs:** Bob might find it cheaper to borrow Euros through a swap than using his own currency.
- **Boost financial stability:** Swapping currencies can provide temporary relief during economic instability or currency crises.

Real-World Examples

- The Reserve Bank of India (RBI) has currency swap agreements with several countries, including Sri Lanka and Japan. This allows RBI to access foreign currency for various purposes, like import payments or foreign debt servicing.

Benefits of Currency Swaps

- **Flexibility:** They offer a customised approach to managing foreign currency needs.
- **Cost-effective:** Swaps can sometimes be cheaper than traditional borrowing or currency exchange.
- **Reduced risk:** Hedging against exchange rate fluctuations can protect against potential losses.

CURRENCY SHOWDOWN: HARD VS. SOFT - A TALE OF STRENGTH AND STABILITY

In the bustling marketplace of currencies, not all are created equal. Some, like the mighty US dollar, stand tall as hard currencies, while others, like the beleaguered Venezuelan bolivar, wobble precariously as soft currencies. What sets these financial titans apart? Let's dive into the fascinating world of currency strength.

Hard Currency: A Global Rock Star

- **Stability:** Hard currencies are the ultimate havens for financial security. Their exchange rates remain relatively stable over extended periods, making them reliable stores of value.
- **Wide Acceptance:** From bustling Tokyo streets to remote Amazonian villages, hard currencies are readily accepted, offering unparalleled liquidity and convenience.
- **Economic Prowess:** Strong economies with robust fiscal policies and diversified industries often birth hard currencies. Think the US, Eurozone, and Japan.

Soft Currency: The Wobbly Warrior

- **Unpredictability:** Soft currencies are notorious for their erratic dance with volatility. Their exchange rates can fluctuate wildly, making them risky bets for long-term investments.
- **Limited Appeal:** Softer currencies struggle to gain widespread acceptance, often confined to their issuing countries or regional pockets.
- **Economic Woes:** Inflation, political instability, and weak economic fundamentals often plague countries with soft currencies, further hindering their strength.

Note:

- As of now i.e., 2023, the US dollar reigns supreme, holding its ground against most major currencies. The Euro and Swiss Franc show resilience, while the British pound faces Brexit-related pressures.
- Soft currencies continue to struggle. The Venezuelan bolivar, despite recent reforms, remains mired in hyperinflation, while the Lebanese pound and Syrian pound grapple with economic and political turmoil.

FOREIGN TRADE: UNLOCKING INDIA'S ECONOMIC POTENTIAL

Foreign trade, the lifeblood of interconnected economies, plays a pivotal role in shaping India's present and future. Beyond simply earning foreign exchange, it serves as a powerful engine for growth and development, offering a multitude of benefits across various facets of the nation. Let's delve into the key objectives of foreign trade for India:

1. Boosting Economic Growth and Diversification

- Foreign trade expands India's global market access, which creates new avenues for export and fosters the growth of domestic industries. This diversification

reduces dependence on the domestic market, insulating the economy from internal shocks.

- Increased exports translate to higher GDP, leading to a larger national pie for all stakeholders. The influx of foreign exchange also facilitates investments in infrastructure, education, and healthcare, laying the foundation for sustainable long-term growth.

Institution Related To Foreign Trade

Department of Commerce: Tasked with formulating foreign trade policy and programs, the department is pivotal in establishing trade relations between nations.

Board of Trade: Responsible for overseeing the government's trade policies, it implements corrective actions as required and maintains trade relations.

Commodity-Specific Organizations: These entities focus on addressing challenges related to specific commodities or groups of commodities within foreign trade. They also aid in export promotion and import management.

Export-Import Bank of India (EXIM Bank): Established in 1982 under the Export Import Bank of India Act 1981, EXIM Bank manages financing programs in the export and import sectors. Additionally, it handles overseas investments made by Indian companies.

2. Enhancing Agricultural Efficiency and Technological Advancement

- Foreign trade exposes Indian farmers to global best practices and innovative technologies in agriculture. Access to advanced seeds, fertilizers, and agricultural machinery can boost productivity, improve crop quality, and enhance farm incomes.
- Collaboration with foreign companies and research institutions fosters technological advancements across various sectors, from manufacturing to pharmaceuticals. This fuels innovation, creates high-skilled jobs, and positions India as a leader in a knowledge-driven global economy.

3. Promoting Quality Standards and Consumer Welfare

- Competition from international markets drives Indian businesses to continuously improve the quality and efficiency of their products and services. This translates to better value for consumers, who benefit from wider choices and competitive prices.
- Foreign trade promotes the adoption of international standards and quality certifications, enhancing India's reputation as a reliable supplier in the global marketplace. This fosters trust and fosters long-term trade partnerships.

4. Job Creation and Global Integration

- Expanding exports create new job opportunities across various sectors like logistics, manufacturing, and services. This reduces unemployment, improves living standards, and strengthens the social fabric of the nation.
- Foreign trade fosters cultural exchange and understanding between nations, promoting international cooperation and building stronger diplomatic ties. This global integration paves the way for collaborative solutions to global challenges like climate change and poverty.

Different Phases of India's Foreign Trade Policy

Phase I: The Cradle of Import Substitution (1950s-1970s)

Imagine a young India, facing a nascent industrial base and limited resources. This era saw a focus on import substitution, with policymakers prioritizing high tariffs and quantitative restrictions to shield domestic industries from foreign competition. The aim was to nurture critical sectors like steel, textiles, and chemicals, which fosters self-sufficiency and building a strong industrial foundation.

While this approach protected domestic industries and laid the groundwork for future growth, it also came with its limitations. The closed economy stifled innovation, limited export opportunities, and resulted in slow economic growth.

Phase II: Embracing Export Promotion (1970s-1990s)

Recognizing the need for a more outward-looking approach, India embarked on a gradual shift towards export promotion in the 1970s. This period witnessed initiatives like:

- **Establishment of Export Processing Zones (EPZs):** These tax-haven havens offered duty-free imports and other incentives, attracting foreign investment and boosting export-oriented industries.
- **Cashback incentives for exporters:** Encouraging exporters to tap into global markets and compete effectively.
- **Diversification of the export basket:** Moving beyond traditional goods like textiles and exploring sectors like pharmaceuticals and engineering.

This phase witnessed moderate economic growth as exports gained momentum. However, the pace of import liberalisation remained slow, and the economy was still not fully integrated into the global market.

Phase III: Marching Towards Outward Orientation (1990s-present)

The 1990s marked a turning point, ushering in an era of unprecedented liberalisation and globalisation. India embraced aggressive trade reforms, dismantling import restrictions and welcoming foreign investment with open arms. Key features of this phase include:

- **Significant reduction in import tariffs and quantitative restrictions:** Opening up the domestic market to foreign competition and which fosters a more competitive environment.

- **Abolishment of the Foreign Investment Promotion Board (FIPB):** Streamlining the process of foreign direct investment (FDI) and attracting global players to invest in India.
- **Free Trade Agreements (FTAs):** Establishing preferential trade arrangements with key partners like the US and ASEAN, further boosting market access for Indian exports.
- **Focus on service exports and new technology sectors:** Recognizing the burgeoning importance of services and knowledge-based industries in the global economy.

This outward orientation resulted in rapid economic growth, propelling India to become a major player in international trade. However, **challenges** remain, like **rising trade protectionism, global economic slowdown, and domestic infrastructure bottlenecks.**

Foreign Trade Policy 2015-2020

The Foreign Trade Policy 2015-2020 introduced various initiatives and changes to enhance India's export sector:

Policy Modifications

- Introduction of MEIS (Merchandise Export from India Scheme) and SEIS (Service Exports from India Scheme) to replace multiple export incentive schemes.
- Consolidation of export incentives under MEIS, offering duty credit scrips without attached conditions.
- SEIS now compensates all service providers delivering services from India.
- Increased incentives for Special Economic Zones (SEZs) under MEIS and SEIS.

Exporter Recognition

- Simplified certification for Export House, Star Export House, and other categories.
- Recognition of Status Holders with privileges to facilitate trade transactions.

Dispute Resolution and Support

- Addition of a chapter on Quality Complaints and Trade Disputes to settle disputes between exporters and importers.
- Support to agriculture and village industry products at global rates under MEIS.

Institutional Mechanisms

- Establishment of the Board of Trade and the Council for Trade Development and Promotion (CTD) for regular stakeholder communication.
- Development of the Centre for Research in International Trade to enhance research capabilities and assist developing countries in trade matters.

Mid-term Review Modifications

- Increased MEIS incentives for ready-made garments and made-ups by 4%.
- Extended the validity of Duty Credit Scrips from 18 to 24 months.
- Extended the duration of FTP 2015-20 until March 31, 2022.

Note:

- The Directorate General of Foreign Trade (DGFT) and its regional offices, under the Ministry of Commerce and Industry, control and regulate India's export trade.

Benefits

- Combined multiple export incentives into MEIS and SEIS, providing duty credit scrips for import duty payments.
- Reduced export obligation under EPCG for locally produced capital goods.
- Self-certification for "status holders" for special treatment under bilateral and regional trade agreements.
- Identified 108 MSME clusters for targeted interventions to enhance exports.

Limitations

- WTO ruling in 2019 against India's export subsidy measures, including MEIS and SEIS, leading to their repeal.
- Challenges with Free Trade Agreements (FTAs) and India's decision not to join RCEP, impacting its export potential.

Agri Export Policy 2018

Vision: Launched in 2018, the Agriculture Export Policy (AEP) aims to harness the untapped potential of Indian agriculture and transform it into a global powerhouse.

Objectives

- **Double farm exports:** From $30 billion in 2018 to $60 billion by 2022, it aims for $100 billion by 2030.
- **Shift gears:** Expand beyond staples, prioritizing high-value products like processed foods, organics, and perishables.
- **Level the playing field:** Create a stable and predictable policy environment for long-term investments in agriculture.
- **Build bridges:** Open new markets through trade fairs, market research, and Free Trade Agreements.
- **Empower farmers:** Enhance access to credit, insurance, and skill development to navigate global markets.

Key Pillars of AEP

- **Diversifying the export basket:** Moving beyond traditional staples, AEP prioritizes high-value and value-added products like processed foods, organic produce, and perishables, catering to evolving global demands.
- **Creating a stable trade environment:** AEP emphasizes a consistent and predictable policy framework to encourage long-term investments and planning in the agricultural sector.
- **Production Infrastructure:** Investments in cold chain facilities, warehousing, and processing units aim to minimize post-harvest losses and enhance product quality.

- **Market Access:** Promoting participation in international trade fairs, facilitating market research, and negotiating Free Trade Agreements (FTAs) open up new markets for Indian exporters.
- **Credit and Insurance:** Ensuring easy access to trade finance and crop insurance schemes mitigate risks and empower farmers and exporters.

India's Foreign Trade Policy 2023

Objectives

1. Boost Exports and Achieve Ambitious Targets

- Double merchandise and services exports to $2 trillion by 2030.
- Increase agricultural exports to $60 billion by 2025.
- Diversify the export basket by promoting high-value goods like pharmaceuticals, electronics, and engineering products.

2. Enhance Ease of Doing Business for Exporters

- Streamline customs procedures and reduce compliance burden.
- Improve trade infrastructure and logistics efficiency.
- Facilitate access to trade finance and credit insurance.
- Promote digitalization and adoption of e-commerce platforms.

3. Foster Economic Growth and Job Creation

- Expand domestic manufacturing through initiatives like Make in India and PLI schemes.
- Create a skilled workforce for export-oriented industries.
- Boost regional development and generate employment opportunities.

Key Pillars of The Policy

- **Incentives to Remission:** Instead of just offering subsidies, the policy encourages exports through duty exemptions, rebates, and other remissions, making Indian goods more competitive globally.
- **Collaborative Export Promotion:** Exporters, states, districts, and Indian Missions join hands to identify opportunities, address challenges, and build a robust export ecosystem.
- **Ease of Doing Business:** Technology takes center stage with automated processes, reduced fees, and IT-based schemes, simplifying export procedures and saving time and money.
- **Emerging Areas:** E-commerce emerges as a key focus, with plans for dedicated hubs and streamlined regulations to unlock its vast potential. Developing districts are nurtured as export hubs, empowering local businesses.
- **Process Re-Engineering:** Manual interfaces are replaced with automated systems, like rule-based duty exemption schemes, making things faster and clearer.
- **Towns of Export Excellence (TEEs):** Four new TEEs join the existing network, providing access to special benefits and fosters growth in these regions.
- **Recognition of Exporters:** Status holders become partners in capacity building, sharing their expertise with aspiring exporters. Re-calibrated norms make it easier to achieve higher status ratings and unlock better branding opportunities.
- **Promoting Exports from Districts:** State and District Export Promotion Committees identify local export potential and develop district-specific action plans, taking exports closer to the grassroots.
- **Streamlining Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) Policy:** Robust export control systems ensure access to high-end technologies for Indian exporters while complying with international treaties.
- **Facilitating E-Commerce Exports:** The policy outlines plans for e-commerce hubs, addressing payment reconciliation, returns, and other challenges to unlock this massive potential.
- **EPCG Scheme Enhancements:** Prime Minister Mega Integrated Textile Region and Apparel Parks (PM MITRA) and Green Technology products like electric vehicles benefit from the scheme.
- **Advance Authorization Scheme Improvements:** Apparel and clothing sector can access the scheme through self-declaration for faster order execution. The Self-Ratification Scheme for input-output norms is extended to more exporters.
- **Amnesty Scheme:** A one-time opportunity for exporters to regularize pending cases of default in export obligations.

India's Foreign Trade in Recent Years (2017-2023)

Year	Exports (USD Billion)	Imports (USD Billion)	Trade Balance (USD Billion)	Growth (%)
2023 (Estimated)	422	618	–196	7.0%
2022	422	618	–196	43.6%
2021	355	466	–111	26.3%
2020	303	380	–77	–5.5%
2019	314	379	–65	8.7%
2018	300	419	–119	11.3%

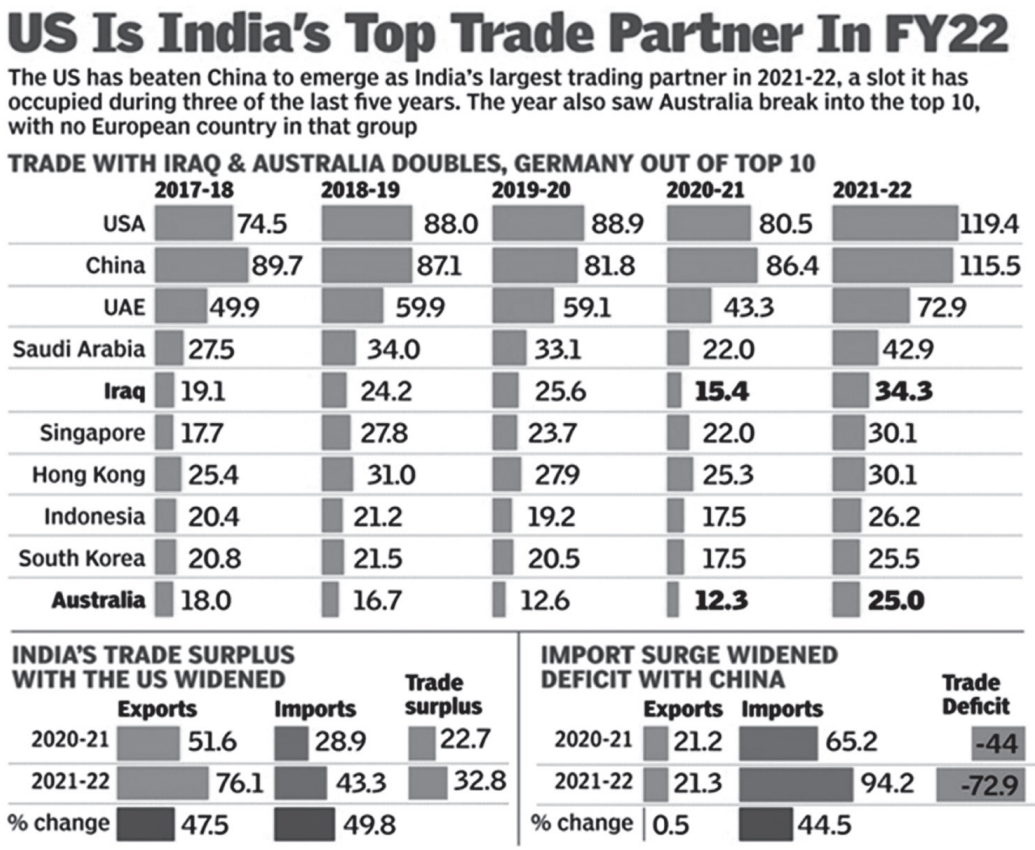

US Is India's Top Trade Partner In FY22
The US has beaten China to emerge as India's largest trading partner in 2021-22, a slot it has occupied during three of the last five years. The year also saw Australia break into the top 10, with no European country in that group
TRADE WITH IRAQ & AUSTRALIA DOUBLES, GERMANY OUT OF TOP 10
2017-18 2018-19 2019-20 2020-21 2021-22
USA 74.5 88.0 88.9 80.5 119.4
China 89.7 87.1 81.8 86.4 115.5
UAE 49.9 59.9 59.1 43.3 72.9
Saudi Arabia 27.5 34.0 33.1 22.0 42.9
Iraq 19.1 24.2 25.6 15.4 34.3
Singapore 17.7 27.8 23.7 22.0 30.1
Hong Kong 25.4 31.0 27.9 25.3 30.1
Indonesia 20.4 21.2 19.2 17.5 26.2
South Korea 20.8 21.5 20.5 17.5 25.5
Australia 18.0 16.7 12.6 12.3 25.0
INDIA'S TRADE SURPLUS WITH THE US WIDENED
Exports Imports Trade surplus
2020-21 51.6 28.9 22.7
2021-22 76.1 43.3 32.8
% change 47.5 49.8
IMPORT SURGE WIDENED DEFICIT WITH CHINA
Exports Imports Trade Deficit
2020-21 21.2 65.2 -44
2021-22 21.3 94.2 -72.9
% change 0.5 44.5

Fig. 11.21: India's Trade Dynamics with Other Countries

Key Aspects of India's Trade

	2019	2020	2021
Export performance (in per cent)			
Share in World Merchandise Exports	1.7	1.6	1.8
Share in World Commercial Services Exports	3.5	4.0	4.0
Share in World Merchandise Plus Services Exports	2.1	2.1	2.2
Import Performance (in per cent)			
Share in World Merchandise Imports	2.5	2.1	2.5
Share in World Commercial Services Imports	3.0	3.2	3.5
Share in World Merchandise Plus Service Imports	2.6	2.3	2.7
India's rank in world trade			
Merchandise Exports	18	21	
Merchandise Imports	10	14	
Service Exports	8	7	
Service Imports	10	10	
Source: DGFT, Monthly Foreign Trade Statistics, November 2022 (based on data till October 2022)			

BARRIERS TO TRADE IN INDIA: NAVIGATING THE ROADBLOCKS

Despite boasting incredible potential, India's international trade journey faces hurdles in the form of various barriers. Let's unpack some key challenges:

Tariff Barriers

- **High import duties:** These inflate the cost of imported goods, making them less competitive and discouraging overseas trade.
- **Complex tariff structure:** Navigating numerous duty rates and exemptions can be cumbersome and time-consuming, adding bureaucratic layers.

- **Anti-dumping measures:** Concerns about unfair pricing practices can lead to sudden import restrictions, disrupting trade flows.

Non-Tariff Barriers

- **Infrastructure bottlenecks:** Inefficient ports, roads, and logistics networks increase transportation costs and delays, hampering export competitiveness.
- **Licensing and regulatory hurdles:** Stringent paperwork, approvals, and compliance requirements add complexity and discourage smaller businesses from exporting.
- **Lack of trade facilitation:** Limited access to trade finance, inadequate marketing infrastructure, and weak export promotion efforts hinder export competitiveness.
- **Technical barriers to trade (TBTs):** Varying product standards and testing requirements in India can diverge from international norms, creating market access hurdles.

Other Challenges

- **Fragmented domestic market:** Small and dispersed domestic demand for export-oriented goods can limit economies of scale and discourage production for export.
- **Limited skilled workforce:** Gaps in specific skills needed for high-value exports can constrain export diversification and growth.
- **Limited access to credit:** High borrowing costs and limited access to financing, especially for SMEs, can restrict export potential.

Overcoming The Barriers

India is actively working to address these challenges through initiatives like:

- **Trade policy reforms:** Reducing tariffs, simplifying regulations, and improving trade facilitation measures.
- **Infrastructure development:** Investing in port modernization, road upgrades, and logistics networks.
- **Digitalization of trade processes:** Streamlining documentation, approvals, and access to trade finance through online platforms.
- **Skill development programs:** Upskilling the workforce to meet the demands of export-oriented industries.
- **Export promotion programs:** Providing financial and marketing support to exporters, particularly SMEs.

Recent Developments and Initiatives

- **Free Trade Agreements (FTAs):** The Indian government has actively pursued FTAs with countries like the UAE and Australia, aiming to reduce tariffs and improve market access for Indian exports.
- **Production-Linked Incentive (PLI) scheme:** This scheme, launched in 2020, offers incentives to companies based on production and exports in 14 key sectors, aiming to boost domestic manufacturing and reduce dependence on imports.
- **National Logistics Policy (NLP 2022):** This policy aims to address logistical bottlenecks by investing in infrastructure, promoting digitalization, and streamlining processes, ultimately reducing transaction costs and improving trade efficiency.

Note:

While India has been working to reduce overall tariff levels, the average applied tariff still stands at **14.5% as of 2022,** according to the World Trade Organization (WTO) Trade Facilitation Database. This remains higher than the global average of around 3%.

While improvements have been made, the average port dwell time in India is still around **3.5 days as of 2022,** compared to global benchmarks of under 2 days.

UNTAPPING INDIA'S GATS POTENTIAL: FROM TOURISTS TO GLOBAL HUBS

The General Agreement on Trade in Services (GATS) under the **World Trade Organization (WTO)** opens doors for international services trade, and India holds significant advantages in two crucial modes: **Mode 2 (consumption abroad),** where consumers travel to India for services like tourism, education, and healthcare, and **Mode 3 (commercial presence),** where foreign companies establish subsidiaries or branches in India. However, despite immense potential, India hasn't fully capitalized on these opportunities. Let's dive into how India can unlock its GATS potential and become a global hub for these sectors:

Mode 1: Unleashing The Tourist Tide

- **Beyond the Taj Mahal:** While India boasts iconic attractions like the Taj Mahal, its tourism landscape often overlooks breathtaking natural beauty, rich cultural diversity, and vibrant wildlife experiences. Diversifying offerings beyond traditional hotspots and promoting lesser-known regions can attract new tourist segments.
- **Visa on Arrival for More:** Expanding the visa-on-arrival program to include more nationalities can ease travel logistics and encourage spontaneous adventures. Streamlining immigration processes and reducing wait times can further enhance the visitor experience.
- **Beyond the Big Cities:** While metro cities have established tourism infrastructure, untapped potential lies in border areas like the Northeast. Investing in tourism infrastructure, promoting local cuisines and cultural experiences, and highlighting natural beauty can unlock these hidden gems.

Mode 2: Healthcare Hub with a Global Reach

- **Beyond Metros:** Medical City Network: While India's top hospitals attract medical tourists, establishing a network of high-quality medical facilities in strategic locations,

particularly in border areas, can cater to regional demand and offer cost-effective alternatives for international patients.

- **Specialization is Key:** Focusing on medical niches like Ayurveda, yoga, and alternative therapies can leverage India's unique strengths and cater to specific patient needs. Investing in research and development in these areas can further solidify India's position as a global healthcare leader.

Mode 3: Education: From Domestic Giants to Global Magnets

- **World-Class Campuses:** While India boasts numerous universities, many lack global recognition. Partnering with top international universities to establish joint campuses or offering dual degrees can attract foreign students and elevate India's academic standing.
- **Beyond Degrees:** Vocational and Skill Development: Focusing on vocational training and skill development programs aligned with global industry needs can attract foreign students seeking practical knowledge and job opportunities.
- **Retaining Talent:** Streamlining the process for foreign students to convert student visas into work visas can incentivize them to stay and contribute to India's workforce.

Free Trade Agreements (FTAs) and Preferential Trade Agreements (PTAs)

Definition and Scope

- FTAs and PTAs aim to reduce or eliminate customs tariffs and non-tariff barriers between participating countries or trade blocs.
- While each member maintains its tariff structure for non-members, FTAs encompass a broader scope, covering goods, services, and other aspects like intellectual property rights (IPRs), investments, and competition policy.
- PTAs primarily entail agreements to reduce tariffs on specific tariff lines, known as the positive list. An example is the India—MERCOSUR PTA involving countries like Argentina, Brazil, Paraguay, and Uruguay.

India's Perspective on Regional Trading Arrangements (RTAs)

- India views RTAs as essential components that complement the multilateral trading system, with about 50% of global trade occurring within FTAs.

India's Engagements and Initiatives

- India is engaged in agreements like CECA and CEPA, which aim for comprehensive economic cooperation in goods, services, investments, and other identified areas with various countries like Sri Lanka, South Korea, Japan, ASEAN, Malaysia, and Singapore.
- The Early Harvest Scheme (EHS) serves as a prelude to FTAs, allowing countries to identify products for tariff liberalization as part of confidence-building measures. For instance, India-Thailand signed an EHS in 2003.

CECA/CEPA Compared To Traditional FTAs

- CECA/CEPA agreements are more comprehensive and ambitious, encompassing various areas beyond goods, including services, investments, regulatory aspects, mutual recognition agreements (MRAs), competition policies, and dispute resolution mechanisms.

Pros and Cons of FTAs

Pros

- **Open Doors to New Markets:** FTAs tear down tariff walls and other trade barriers, making it easier for businesses to waltz into new markets. Just imagine Indian shoemakers effortlessly stepping into Thailand, thanks to their FTA, leaving Canadian competitors with a hefty tariff tap on their shoulder.
- **Export Advantage:** FTAs create preferential lanes for member countries. Think of it as a VIP pass, giving Indian leather shoes an edge over Canadian competitors in ASEAN markets.
- **Investment Tango:** FTAs can attract foreign investment, bringing in much-needed capital and dancing partners for growth. Multinational companies might find India's FTA-fueled market an irresistible rhythm to join.
- **Beyond Tariffs:** The music extends beyond just tariffs. FTAs can harmonize regulations through Mutual Recognition Agreements (MRAs), making life easier for businesses and consumers alike.
- **Multilateral Frustration:** When multilateral trade negotiations become a slow waltz, stuck on complex issues, FTAs emerge as a faster foxtrot, allowing countries to take the lead in their own economic steps.
- **Competitive Edge:** FTAs can push domestic economies to hone their skills and become nimble dance partners on the global stage. Access to cheaper imports can fuel value addition and propel them into the export arena.
- **Global Value Chain:** FTAs can act as tickets to the exclusive club of global value chains, where countries specialize in their strengths and tango together to create finished products.

Cons

- **Industrial Waltz Over?** Domestic industries might find themselves struggling to keep up with the energetic imports, potentially facing "de-industrialization" – the rhythm of production slowing down or even stopping.
- **MNC Crowd Out:** Foreign giants might waltz in and steal the spotlight, pushing domestic players off the dance floor.
- **Lost Revenue:** When tariffs vanish, so does some government revenue. It is like skipping a beat in the budget's song.

- **Environmental Mishap:** The pursuit of "growth at any cost" can lead to irreversible environmental damage, compromising health and well-being – a risky step in the trade tango.
- **Food Insecurity:** If domestic agriculture gets sidelined, food security might become a shaky partner in the economic dance.
- **Scale Matters:** Smaller economies might find it harder to keep up with the complex steps of some FTAs, potentially missing out on the benefits.
- **Trade Diversion Blues:** Instead of creating new trade partnerships, FTAs can divert trade away from non-member countries, like a jealous dance partner cutting in on another's groove.

Trade Creation and Trade Diversion

- **Trade Creation and Trade Diversion: Trade creation means that a free trade area creates trade that would not have existed otherwise.**
- It is because of price advantage, specialization, benefits of scale as well as the general buoyancy in the economy due to a durable larger market.
- It means more employment, more domestic taxes and general welfare of all.
- Trade diversion means that a free trade area diverts trade away from a more efficient supplier outside the FTA towards a less efficient supplier within the FTA.
- It means tariffs are the only influential factor and there is no realisation of aims of FTAs.

Difference Between FTA and PTA

Feature	Free Trade Agreement (FTA)	Preferential Trade Agreement (PTA)
Scope	Covers a wider range of goods and services, potentially including non-tariff barriers.	Covers a limited number of goods and services, typically specified in a "positive list."
Tariffs	Generally uses a negative list, outlining exceptions where tariffs remain (e.g., agricultural products).	Uses a positive list, specifying products on which tariffs are reduced or eliminated.
Non-tariff barriers	May address non-tariff barriers like customs procedures and technical regulations.	Usually focuses primarily on tariff reduction, with limited or no attention to non-tariff barriers.
Level of ambition	Generally considered more ambitious due to broader scope and deeper integration.	Less ambitious than FTAs, offering limited benefits due to the restricted scope.
Negotiation complexity	More complex negotiations involving a wider range of issues.	Simpler negotiations focusing on a smaller number of goods and tariff reductions.
Examples	India-ASEAN FTA, Comprehensive Economic and Trade Agreement (CETA) between Canada and EU .	India-MERCOSUR PTA

Make in India: Vision and Pillars

Launched in 2014, Make in India aims to transform India into a global manufacturing hub, attracting foreign direct investment (FDI) and driving domestic industrial growth. It focuses on key sectors like automobiles, electronics, pharmaceuticals, and textiles, leveraging India's abundant labor, growing consumer market, and strategic location.

Branding Strategies

To achieve its goals, Make in India employs a multi-pronged branding strategy:

- **Simplified Regulations:** Removing bureaucratic hurdles and streamlining approval processes makes India a more attractive investment destination.
- **Skilled Workforce Development:** Investing in vocational training and skill development programs ensures a readily available workforce for new industries.
- **Infrastructure Upgradation:** Modernizing ports, roads, and logistics networks creates a conducive environment for manufacturing and trade.
- **Tax Incentives:** Offering tax breaks and other fiscal benefits entices foreign companies to set up production facilities in India.
- **Marketing and Promotion:** Leveraging digital platforms and global events, Make in India showcases India's manufacturing potential to potential investors and partners.

Impact on The Indian Economy

- **Increased FDI:** Since its launch, Make in India has attracted billions of dollars in FDI, boosting industrial growth and job creation.
- **Export Diversification:** By promoting manufacturing across various sectors, India is moving beyond traditional exports and establishing itself in high-value segments.
- **Technological Upgradation:** Collaboration with foreign companies brings advanced technologies and know-how to India, enhancing its domestic capabilities.

- **Strengthened Brand Image:** Make in India is transforming India's perception from a service-oriented economy to a manufacturing powerhouse, attracting talent and investment.

Challenges and Future Focus

Despite its successes, Make in India faces challenges:

- **Implementation Bottlenecks:** Streamlining complex regulations and overcoming bureaucratic hurdles remain crucial.
- **Skill Gap:** Bridge the gap between industry demand and workforce skills to fully capitalize on the initiative's potential.
- **Infrastructure Gaps:** Continued investment in logistics, power, and connectivity is essential for sustained growth.
- **Sustainable Development:** Balancing industrial growth with environmental and social considerations is vital for long-term success.

Make in India represents a bold vision for India's economic future. By effectively leveraging its branding strategies, addressing challenges, and ensuring sustainable development, India can not only build a vibrant manufacturing sector but also reshape its global image as a dynamic and reliable economic partner.

Major Schemes in India to Promote Foreign Trade

1. Remission of Duties and Taxes on Exported Products (RoDTEP) Scheme (2021)

- It replaces various export incentive schemes with a single, transparent scheme that refunds embedded duties and taxes on exported goods.
- **Impact:** Makes Indian exports more competitive, simplifies export procedures, and provides immediate liquidity for exporters.

2. Trade Infrastructure For Export Scheme (TIES)

- It aims to develop export-oriented infrastructure such as common effluent treatment plants, cold storage facilities, and testing labs.
- **Impact:** Reducing logistics costs, improving export competitiveness, and facilitating exports of perishables and value-added products.

3. Duty Exemption and Remission Scheme

- The Duty Exemption and Remission Scheme encompasses both export and import activities. It ensures duty-free import of goods used in the production of exports. This scheme operates through four distinct sub-parts:
  - Advance Authorisation Scheme
  - Advance Authorisation for Annual Requirement
  - Duty Free Import Authorisation Scheme
  - Duty Drawback of Customs/Central Excise Duties/ Service Tax

4. Export Promotion Capital Goods (EPCG) Scheme

The Export Promotion Capital Goods (EPCG) Scheme pertains to both exports and imports.

- It allows the duty-free import of capital goods crucial for boosting India's export competitiveness in the global market.

5. Served From India Program

- The aim is to boost the export of services and establish a distinctive global brand, Served From India, recognized and respected internationally.
- Eligibility is determined based on achieving a specified minimum level of foreign exchange earnings.
- Participants receive Duty Credit scrip, enabling them to offset the duty paid on a portion of their imports against future imports.

6. Market Access Initiative (MAI)

- MAI scheme is intended to provide financial assistance for medium-term export promotion efforts with a sharp focus on a country/product.
- Financial assistance is available for Export Promotion Councils (EPCs), Industry and Trade Associations (ITAs), Agencies of State Governments, Indian Commercial Missions (ICMs) abroad and other eligible entities, as may be notified. A whole range of activities can be funded under the MAI scheme. Amongst various others, these include:
  - Market studies
  - Setting up of showrooms/warehouses
  - Sales promotion campaigns
  - International departmental stores
  - Publicity campaigns
  - Participation in international trade fairs
  - Brand promotion

CONCLUSION

India's external sector dances between promising potential and pressing hurdles. Export growth shines, fueled by diversification and ambitious goals. By tackling challenges and seizing opportunities, India can transform its external sector into a resilient engine of global prosperity.

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